

September 30, 2005



Financial Management

Report on Development of the DoD Baseline for Military Equipment (D-2005-114)

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Office of Inspector General

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Acronyms

AT&L	Acquisition, Technology, and Logistics
CAMS-ME	Capital Asset Management System - Military Equipment
CFO	Chief Financial Officer
DFAS	Defense Finance and Accounting Service
FFMIA	Federal Financial Management Improvement Act
FMR	Financial Management Regulation
GAO	Government Accountability Office
OMB	Office of Management and Budget
PMO	Program Management Office
RDT&E	Research, Development, Test and Evaluation
SFFAS	Statement of Federal Financial Accounting Standards
USD	Under Secretary of Defense
USSGL	United States Standard General Ledger



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September 30, 2005

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,
TECHNOLOGY AND LOGISTICS/ACQUISITION
RESOURCES AND ANALYSIS
UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

Subject: Report on Development of the DoD Baseline
for Military Equipment (Report No. D-2005-114)

We are providing this report for review and comment. We considered management comments on the draft report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics comments were partially responsive. We request additional comments on Recommendations A.1, A.2, A.3, D, and E by October 30, 2005.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to AudDFS@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Barbara A. Sauls at (703) 325-5782 (DSN 221-5782) or Mrs. Alice F. Carey at (703) 325-6839 (DSN 221-6839). The team members are listed inside the back cover. For the report distribution, see Appendix E.

By direction of the Deputy Inspector General for Auditing:

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Department of Defense Office of Inspector General

Report No. D-2005-114

September 30, 2005

(Project No. D2005-D000FH-0033.001)

Development of the DoD Baseline for Military Equipment

Executive Summary

Who Should Read This Report and Why? This report is intended for use by officials in the Property and Equipment Policy Office (Policy Office) in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics. The report discusses the adequacy of the methodology for determining the value of military equipment.

Background. The Policy Office requested that we perform this examination to review the methodology it developed to accurately identify and value all military equipment. This is the second of two reports about the methodology the Policy Office developed. The first report discussed the agreed-upon procedures, auditor actions, and results. This one discusses the significant auditor findings, conclusions, and recommendations.

To meet the objective of obtaining a clean audit opinion, DoD must comply with all government accounting standards, including Statement of Federal Financial Accounting Standard No. 23, "Eliminating the Category of National Defense Property, Plant, and Equipment," May 2003, which requires DoD to include the cost of its military equipment on the DoD Balance Sheet. To comply with the new standard, the Policy Office developed and began implementing a conceptual model that described the business and systems process requirements DoD believed were needed to accurately value, depreciate, and financially report military equipment. The first phase of the conceptual model, the baseline valuation, was primarily a manual effort to determine the historical cost for military equipment as of September 30, 2006.

Results. The Policy Office methodology did not properly support the cost of recently acquired military equipment. As a result, the Policy Office effort may produce financial statement values that will not adequately address DoD decision makers' information needs. The Deputy Director of the Policy Office should determine the availability of source documentation to support the valuation and use this available historical cost supporting documentation to value military equipment. (finding A)

To properly update the military equipment baseline, the Policy Office will have to overcome significant challenges related to system capabilities, acquisition valuation data, asset quantity data, and personnel training. As a result, the Policy Office risks not being able to update the baseline value of military equipment successfully by the aggressive target date of September 30, 2006. The Deputy Director of the Policy Office should identify specific milestones that would address the risks involved in updating the baseline value of military equipment and regularly report the status of the milestones to the Under Secretary of Defense (Comptroller/Chief Financial Officer) and the Under Secretary of Defense for Acquisition, Technology, and Logistics. Those Under Secretaries should use the status reports to assess whether the Department is likely to meet its goal of a military equipment baseline value, and revise the target date until the Department has implemented a fully tested and integrated system, including

the necessary interfaces and portals, that is capable of updating and sustaining the baseline value of military equipment. (finding B)

In addition, the Policy Office used a methodology that was not in accordance with generally accepted accounting principles to capitalize and depreciate modification costs. As a result, the baseline valuation model incorrectly calculated the estimated net book value of military equipment programs with modifications. The Deputy Director of the Policy Office should revise the baseline valuation methodology to use either the “capitalization per end item” or “capitalization as a separate item” approach to capitalize and depreciate military equipment modifications or both. (finding C)

Further, we could not verify the validity of 12 of the 29 waivers in our sample. Without verifying the validity of the waivers, we could not ensure that the military equipment universe included all valid programs and excluded all invalid programs, which could cause the value of military equipment to be misstated in the financial statements. The Deputy Director of the Policy Office should verify the validity of the waivers before acceptance, and accept the waiver only if the program managers have provided adequate supporting documentation to allow independent verification. (finding D)

Finally, the Policy Office used a questionnaire that did not require the program manager to affirm support for the valuation amounts that the Policy Office had calculated for the military equipment programs. The military equipment valuation amount may be more reliable with a signed attestation. The Deputy Director of the Policy Office should require program managers to sign attestations to affirm their concurrence with the accuracy and validity of the military equipment valuation amount for their respective programs. (finding E) See the Findings section of the report for the detailed recommendations.

Management Comments. The Director of the Acquisition Resources and Analysis Office concurred with four of the recommendations, nonconcurred with two of the recommendations, and partially concurred with four of the recommendations. See the Finding section of the report for a discussion of the management comments and the Management Comments section of the report for the complete text of the comments. We request that the Director provide comments on the final report by October 30, 2005.

Management Actions. During the engagement, we developed and submitted to the Policy Office three issue papers discussing the lack of source documentation for recently acquired military equipment, concerns with the update methodology, and deficiencies in the baseline approach. In response, the Policy Office began implementing corrective actions to resolve the issues. Specifically, the Policy Office began holding meetings with Defense Finance and Accounting Service field offices to determine the availability of historical cost documentation. Additionally, the Policy Office revised the baseline update methodology and incorporated an attestation requirement into the valuation process. The Policy Office also prepared a draft position paper that described a revised methodology to value modifications.

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Background

This is the second of two reports that discuss agreed-upon procedures we used to review the development of the DoD baseline for military equipment. This report provides a detailed discussion of significant issues related to:

- source documentation,
- updates to the military equipment baseline,
- accounting for modifications,
- waivers to military equipment valuation, and
- attestations of valuations.

Conceptual Model. To meet the objective of obtaining a clean audit opinion, DoD must comply with all government accounting standards, including Statement of Federal Financial Accounting Standard (SFFAS) No. 23, “Eliminating the Category of National Defense Property, Plant, and Equipment,” May 2003, which requires DoD to include the cost of its military equipment on the DoD Balance Sheet. Therefore, the Office of Secretary of Defense developed and has been implementing a conceptual model that describes the business processes and systems requirements DoD believes are needed to accurately value, depreciate, and financially report military equipment. The model consists of three phases: the Baseline Valuation, the Midterm Solution, and the implementation of the Business Enterprise Architecture.

Baseline Valuation. The first phase of the conceptual model, the baseline valuation, is a manual effort to determine the historical cost for military equipment acquired as of September 30, 2006. The Property and Equipment Policy Office (Policy Office) in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics plans to use information derived from acquisition and budget documents to periodically update and record a single set of adjusting accounting entries during the fourth quarter of FY 2006.

Midterm Solution. The next phase, the Midterm Solution, will leverage existing systems and processes to maintain the baseline valuations, manage work-in-process, and calculate cost for military equipment acquired after September 30, 2006. The midterm solution will capture cost as it is incurred at the transaction level by contract. According to the Policy Office, the midterm system solution would be based on Cabrillo, the Department of the Navy’s Capital Asset Management System and would be known as Capital Asset Management System - Military Equipment (CAMS-ME).

Business Enterprise Architecture. The Policy Office has scheduled the final phase, the Business Enterprise Architecture implementation, to begin around FY 2012. Once implemented, data will be entered only once and flow seamlessly through systems and across functional areas to support DoD business needs and processes. To lead the effort of developing and implementing a Business

Enterprise Architecture conceptual model, the Under Secretary of Defense (USD) for Acquisition, Technology, and Logistics (AT&L) and the USD (Comptroller)/Chief Financial Officer created the Property and Equipment Policy Office. The Policy Office will establish policies to properly record and value military equipment. The Policy Office is responsible for developing future and interim architecture requirements, policies, and system solutions and a transition plan to achieve compliant financial accounting and reporting for military equipment. To assist in the baseline phase, the Policy Office hired KPMG, a public accounting firm, to assist DoD Components with establishing and sustaining the historical cost baseline. Among other tasks, the Department contracted with KPMG to assist as follows.

- to develop and implement business rules and policies that relate to valuing military equipment in accordance with generally accepted accounting principles, Department regulations, and other applicable laws and regulations
- to identify data requirements that need to be embedded in the Enterprise Data Model
- to develop an auditable historic cost baseline by conducting individual program valuations and preparing related documentation packages that meet all audit requirements
- to implement processes and systems for capturing, maintaining, and updating the military equipment values for DoD Components
- to support project management of the systems solution and the further development of requirements and business processes as well as the analysis and design of the CAMS interfaces with the Military Departments

Objectives

Our overall audit objective was to evaluate the development of the DoD baseline for military equipment valuation. Specifically, we evaluated whether the valuations of military equipment that the Office of the Secretary of Defense had completed and the waiver criteria that it used to exclude projects from the valuation process were supportable. We also performed procedures to evaluate whether the military equipment universe was complete. In addition, we reviewed whether the baseline that the Policy Office was developing for military equipment adequately addressed DoD decision makers' information needs. See Appendix A for a discussion of the scope and methodology and Appendix B for prior coverage related to the objectives. Appendix C is a glossary of technical terms used in this report.

A. Support for Military Equipment Valuations

The Policy Office did not properly support the cost of recently acquired military equipment because personnel did not use historical supporting documentation to value the recently acquired or modified military equipment. Instead, they used data obtained from various financial, acquisition, and logistics systems. The use of alternative data was proper when obtaining initial historical costs was not practical; however, historical documentation should have been available on equipment that was acquired recently. Use of alternative data sources when historical documentation should have been available may produce financial statement values that will not adequately address DoD decision makers' information needs.

Document Retention Policy

Statement of Federal Financial Accounting Standards. The Financial Accounting Standards Advisory Board SFFAS No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment," May 2003, requires that initial capitalization of military equipment assets, including any major improvements and modifications, be "based on initial historical cost" in accordance with the asset recognition provisions of SFFAS No. 6, "Accounting for Property, Plant, and Equipment," June 1996, as amended. SFFAS No. 23 recognizes that determining initial historical cost may not be practical for items acquired many years before the effective date of this standard. If obtaining initial historical cost is not practical, estimated historical cost may be used. The basis for estimating historical costs may include budget, appropriation, or engineering documents and other reports reflecting amounts expended. SFFAS No. 23 establishes the financial reporting requirement for military equipment, effective for accounting periods beginning after September 30, 2002.

Records Retention. The Federal Acquisition Regulation, Subpart 4.805, and the National Archives and Records Administration, General Records Schedule No. 3 require that historical records for contracts that exceed the acquisition threshold, such as military equipment contracts, be retained 6 years and 3 months after final payment.

DoD Guidance. The DoD Financial Management Regulation (FMR), volume 5, chapter 21, "Disbursing Office Records," March 2003 and volume 4, chapter 6, "Property, Plant, and Equipment," August 2000 provide guidance concerning supporting documentation retention. Volume 5, chapter 21, designates a retention period of 6 years and 3 months.

DoD FMR, volume 4, chapter 6, "Property, Plant, and Equipment," August 2000 states that original documentation must be maintained in a readily available location during the applicable retention period to permit the validation of information pertaining to the asset, such as acquisition cost, acquisition date,

and cost of improvement. The regulation further states that supporting documentation includes purchase invoices, sales and procurement contracts, DD Form 1354 “Transfer and Acceptance of Military Real Property,” ENG Form 3013 “Work Order/Completion Report,” construction contracts, and work orders generated independently of the entity in possession of the property.

Documentation Used to Support Costs

As of August 27, 2004, the Policy Office had reviewed 326 programs. We judgmentally selected 16 of those programs for review. Later, we selected an additional 6 programs from one of our site visits, for a total of 22 programs. Of the 22 programs, 8 programs contained 2 or more parts. As a result, we reviewed a total of 48 programs and subprograms. Of the 48 programs and subprograms, the Policy Office completed 19 program valuations and granted waivers for 29.

We reviewed the 19 sample items with valuations to determine the reasonableness and accuracy of the valuations. The Policy Office had supported none of the valuations with proper documentation as defined in the DoD FMR. The Policy Office had not based the valuations for recent acquisitions on initial historical cost data, which should have been available. Further, SFFAS No. 23 was effective for accounting periods beginning after September 30, 2002. Consequently, DoD should have had documentation available to support transactions involving the military equipment acquisitions after that date.

Military Equipment Valuation Data Sources

Military Equipment Purchased Before SFFAS No. 23. The Policy Office properly used data obtained from various financial, acquisition, and logistics systems to value military equipment purchased before September 30, 2002. Obtaining initial historical costs was not practical for determining the value of this equipment. The Policy Office used the P-1 Budget Report¹ and the DoD Selected Acquisition Reports² as supporting documentation in valuing many of the programs. These documents were readily available and did not require the time and effort to research and identify available documentation that would properly support the valuation. The Policy Office personnel also used various financial, acquisition, and logistics systems to compile the data for the valuation calculation.

Military Equipment Purchased After SFFAS No. 23. The Policy Office used data obtained from various financial, acquisition, and logistics systems to support recent acquisition values, when historical cost supporting documentation should

¹The P-1 is provided annually to the DoD oversight committee of the Congress coinciding with transmittal of the President’s Budget. The P-1 line items represent funding for active procurement programs per budget year.

²The Selected Acquisition Report summarizes the latest estimates of cost, schedule, quantities, and technical status for major defense acquisition programs.

have been available. While using various sources made it easier to compile the data, it was improper and did not ensure that the resulting valuation was accurate and consistent with primary source documents. The Policy Office needed to ensure the system data used to value military equipment assets were accurate and consistent with the historical cost support documents. Accepting military equipment program costs provided by program offices without further verification assumed that the financial, acquisition, and logistics system information was reliable and accurate. DoD and the Government Accountability Office (GAO) have issued reports that question the accuracy of DoD financial system data.

DoD Performance and Accountability Report for FY 2003. In its Performance and Accountability Report for FY 2003, DoD states in the Management, Discussion, and Analysis Section that "...most legacy property and logistics systems are not integrated with acquisition and financial systems and were not designed to capture the acquisition cost, cost of modifications and upgrades, or to calculate depreciation."³ In the Notes Section, Note No. 10, DoD states the following.

The Department has determined that it is not practical at this time to accumulate from internal records the information necessary to value military equipment in accordance with generally accepted accounting principles, because the Department is currently working to revise its accounting processes and systems to support the informational needs of management and compliance with generally accepted accounting principles. In the interim the Department will base the values of military equipment for financial statement presentation purposes on data provided by the Bureau of Economic Analysis (BEA), Department of Commerce. The data provided by BEA consists of investment and net book value data for 84 groups of equipment such as aircraft, ships and combat vehicles. BEA uses Department budget data for equipment acquisitions and actual quantities of equipment items delivered to calculate the Department's annual investment in equipment.

Government Accountability Office. In GAO Report No. GAO-04-615, "DoD Business Systems Modernization: Billions Continue to Be Invested with Inadequate Management Oversight and Accountability," May 2004, GAO stated, "DoD does not have the ability to produce accurate, reliable, and timely information to make sound decisions and accurately report on its billions of dollars of inventory and other assets." The report further stated that because of these problems, the recorded cost of property, plant, and equipment acquired in recent years in DoD financial systems may not be reliable.

Conclusion

The guidance allows DoD to use financial, acquisition, and logistics systems data for estimating the value of military equipment acquired in an environment in which the historical records were not required to be retained. However, the

³DoD Performance and Accountability Report for FY2003, Management Discussion and Analysis Section.

Policy Office used that methodology for estimating the value of military equipment acquired in an environment in which the historical records should have been available. If DoD relies on systems data that it states may not be accurate, reliable, and timely, it is reasonable to expect that the military equipment valuation based on the data also may not be accurate, reliable, and timely. In addition, future financial statement note disclosures will be required to indicate that DoD has not complied with the requirements of SFFAS No. 23, the DoD FMR, or its proposed methodology because it values military equipment from estimates when actual historical cost supporting documentation should be available. To produce reliable financial statement values, DoD must properly support the cost of recently acquired military equipment with available historical supporting documentation.

Management Actions

During the engagement, we prepared an issue paper that discussed the lack of source documentation and submitted it to the Policy Office. In response, the Policy Office stated that it planned to trace a sample of expenditure transactions to the supporting documents. It began meeting with Defense Finance and Accounting Service (DFAS) representatives to gain an understanding of the best approach for tracing transactions to source documentation and then stated that, as a result of those meetings, it would select a sample of documents and would verify the support. In March 2005, the Policy Office began identifying the programs it will use to demonstrate that the values developed as part of the Military Equipment Valuation project are traceable to the associated supporting documentation.

Recommendations, Management Comments, and Audit Response

Revised Recommendations. As a result of management comments, we revised Recommendations A.2. and A.3. to clarify the issue that actual historical cost information is required to value military equipment acquired during a period when the cost information should have been available.

The Director, Acquisition Resources and Analysis provided comments that included comments from the Deputy Director of the Property and Equipment Policy Office.

A. We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics:

1. Determine the availability of source documentation to support the valuation.

Management Comments. The Director concurred, stating that the Policy Office will determine the availability of appropriate supporting documentation. In addition, the Policy Office will determine whether it is practical to accumulate the information to support transactions that occurred after the effective date for SFFAS No. 23. However, the Director voiced concerns about the practicality of locating documentation to support the cost of many equipment programs.

Auditor Response. The Director's comments were partially responsive. SFFAS No. 23 recognizes that determining initial historical cost may not be practical for items acquired many years before the effective date of the standard. However, the Federal Acquisition Regulation, the National Archives and Records Administration, and the DoD FMR require the retention of contract documentation. Consequently, when DoD asserts that it is ready for audit, it should be asserting that documentation is available to support transactions involving military equipment acquisitions after the standard's effective date, as a minimum. We request that the Director reconsider her position on the importance of locating documentation to support cost of equipment acquired after SFFAS No. 23 became effective, and provide comments on the final report.

2. Use available historical cost supporting documentation in its methodology to value recently acquired military equipment and use other source documents only if historical cost supporting documentation is not available and obtaining it is not practical.

Management Comments. The Director partially concurred, stating that SFFAS No. 23 provides for the use of alternative data sources if obtaining initial historical cost is not practical. The Director further stated that when her office defines "appropriate supporting documentation," it will determine the availability of such documentation. She stated that her office will determine whether it is practical to accumulate the information to support transactions that occurred after the standard's effective date.

Auditor Response. The Director's comments were partially responsive. As reiterated in the management comments the two key concepts of SFFAS No. 23 are the *availability* of documentation and the *practicality* of accessing it. We agree that the standard provides for the use of alternative data sources when obtaining initial historical cost is not practical. However, we also interpret the intent of the standard to mean that recent source documentation *will* be available and that it *will* be practical to obtain access to it. The Federal Acquisition Regulation, the National Archives and Records Administration, and the DoD FMR all require that supporting documentation be retained 6 years and 3 months after final contract payment. In addition, the DoD FMR requires that original documentation be maintained in a readily available location during the applicable retention period to permit the validation of information pertaining to the asset, such as acquisition cost, acquisition date, and cost of improvement. Collectively, this guidance provides an opportunity for DoD to establish a documentation retention program that ensures support for financial transactions is readily accessible. We request that the Director reconsider her position on the availability of support documentation and provide comments on the final report.

3. Disclose in the financial statement notes that DoD did not comply with the requirements of Statement of Federal Financial Accounting Standard No. 23, if DoD uses estimates in lieu of actual historical cost information to value military equipment acquired during a period when the cost information should have been available.

Management Comments. The Director nonconcurred stating that the methodology the P&E Policy Office used for valuing programs was in full compliance with this standard.

Auditor Response. The Director's comments were nonresponsive. SFFAS No. 23 allows DoD to use financial, acquisition, and logistics systems data for estimating the value of military equipment acquired in an environment in which the historical records were not required to be retained. However, the Policy Office used that methodology for estimating the value of military equipment acquired recently. The historical records for that equipment should have been available. Therefore, the methodology was not in full compliance with SFFAS No. 23. We request that the Director reconsider her position on the P&E Policy Office's compliance with SFFAS No. 23 and the document retention guidance, and provide comments on the final report.

B. Updates to the Military Equipment Baseline

The Policy Office will have to overcome significant challenges to properly update the military equipment baseline value as of September 30, 2006. Those challenges relate to:

- system capabilities,
- acquisition valuation data,
- asset quantity data, and
- personnel training.

The challenges exist because the Department did not have financial and accountability systems that could provide accurate and timely information. To overcome these challenges, the Policy Office depended on the participation of organizations beyond its direct control - the Naval Space and Warfare Systems Center, DFAS, the Program Management Offices (PMOs), and the Military Department Financial Management Components. As a result of these challenges and reliance on organizations beyond its control, the Policy Office is at a high risk of not being able to update the baseline value of military equipment successfully by the aggressive September 30, 2006, baseline date.

Financial Management System Policy

Chief Financial Officers Act of 1990. The Chief Financial Officers (CFO) Act of 1990 requires that an agency CFO develop and maintain an agency financial management system that complies with applicable accounting principles, standards, and requirements; internal control standards; and other policies and requirements prescribed by the Office of Management and Budget (OMB). The agency financial management system must provide complete, reliable, consistent, and timely information for reporting.

Federal Financial Management Improvement Act of 1996. The Federal Financial Management Improvement Act (FFMIA) of 1996 provides for consistent accounting by an agency from one fiscal year to the next and uniform accounting standards throughout the Federal Government. The FFMIA also requires improvement in the performance, productivity, and efficiency of Federal Government financial management, and the establishment of financial management systems to support controlling the cost of the Federal Government. The FFMIA of 1996 requires each agency to implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Standard General Ledger (USSGL) at the transaction level.

Office of Management and Budget Circular A-127. OMB Circular A-127 revised, "Financial Management Systems," July 23, 1993, prescribes policies and standards for agencies to follow in developing, operating, evaluating, and reporting on financial management systems. The OMB Circular states that financial management systems should be designed to provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems. The OMB Circular also states that integrated financial management systems should contain common data elements, common transaction processes, consistent internal control, and efficient transaction entry. Compliance with this standard requires that data in financial reports be consistent with the USSGL, transactions be recorded consistent with the USSGL rules, and supporting transaction detail for USSGL accounts be readily available. Financial management systems should maintain accounting data to permit reporting of financial data in accordance with accounting standards recommended by the Financial Accounting Standards Advisory Board and standards issued by the Director of OMB, and the reporting requirements issued by the Director of OMB and the Secretary of the Treasury.

Baseline Update Methodology

To overcome existing challenges and update the military equipment baseline, the Policy Office will need the assistance of the Naval Space and Warfare Systems Center to adapt the Navy's pilot system, Cabrillo, into the Capital Asset Management System - Military Equipment (CAMS-ME). The Policy Office will also need the cooperation of DFAS to update the required expenditure data. In addition, the Policy Office would need the cooperation of DoD Components to meet the challenges related to asset quantity data.

The Policy Office has developed target dates for the baseline update process. For example, the Policy Office has set a target date of June 1, 2006, for development of interfaces. We suggest the Policy Office further develop those target dates into milestones that DoD management can use to assess the risk that the Department will not meet its goal for a September 30, 2006, baseline.

System Capabilities. The methodology proposed by the Policy Office requires a system capable of updating the initial program valuations as of FY 2006 and maintaining the values until the long-term solution is implemented. The new system will need to meet the following requirements:

- Comply with all statutory and regulatory directions, including the:
 - CFO Act of 1990,
 - Federal Financial Management Improvement Act of 1996, and
 - OMB Circular A-127.
- Account for military equipment in accordance with generally accepted accounting principles and the DoD FMR.

In addition, according to the Policy Office), the system will need to meet the following requirements:

- Recompute the program values with the data collected during the initial program valuations as well as the updated cost and asset information.
- Summarize the results for financial reporting purposes so that DFAS can prepare the journal entries and footnotes for the financial statements.

According to the Policy Office , the midterm systems strategy for the Department builds on the Department of the Navy's Capital Asset Management System. The new system would be known as CAMS-ME and would be based on Cabrillo, an Enterprise Resource Planning⁴ solution implemented for the Space and Naval Warfare Systems Command.

The Policy Office intends that the CAMS-ME will support three functional areas: item acceptance and work-in-process, military equipment valuation, and fixed asset accounting. The Policy Office planned to implement CAMS-ME in three evolutionary or spiral increments of capability.

Increment 1. Increment 1 will focus on automating the spreadsheet-based process for calculating the baseline valuations, updating the baseline in FY 2006, and maintaining the historical cost values. It will be operational by October 1, 2005.

According to the Policy Office, Increment 1-Enhanced, which it plans to deploy by June 1, 2006, would also include an interface with the DFAS Corporate Database to collect expenditure information. The DFAS Corporate Database is the central storage point for all shared data within DFAS.

Increment 2. Increment 2 would focus on calculating asset values at the contract level and would be operational by October 1, 2006.

Increment 3. Increment 3 would focus on automating the interfaces necessary for calculating the "full cost" of an asset on an individual-item basis and would be operational by October 1, 2008.

Acquisition Valuation Data. To bring the program values current as of the end of FY 2006, the Policy Office would have to obtain updated expenditure data for the period between the date of the original program valuations and September 30, 2006. According to the Policy Office, it planned to develop an automated interface with the DFAS Defense Corporate Database with a target date of June 1, 2006. However, the Policy Office did not plan to begin operational testing of the

⁴ Enterprise Resource Planning (ERP) refers to a broad set of business process solutions that integrate the operational components of an organization. ERP enables business process re-engineering, focuses on industry common best practices, and facilitates process improvements. ERP systems provide integrated applications supporting the operations of an enterprise, such as human resources, financial data, sales, planning, purchasing, maintenance, inventory control, customer relationship management, and supplier relationship management.

interface until May 2006 and expected to continue testing the interface through the “soft” or trial closing in June 2006. According to the Policy Office, if development delays occur, the Policy Office could request that DFAS provide the expenditure information in a read file that could be loaded into the new system to update the initial program values.

Asset Quantity Data. Because the program valuations must account for additions and deletions of end items that occur after the initial valuations, the Policy Office must update the quantity of assets. The Policy Office proposes that the Components be responsible for ensuring that the asset quantity data are valid. The Policy Office also proposes that the Service financial managers gather the quantity information by sending data calls to the program managers until it has established the interfaces with the accountability systems. According to the Policy Office, it would then update the asset data by way of a portal.

Personnel Training. A rigorous training program should accompany the transition to the new CAMS-ME system. The Policy Office contracted with KPMG to provide assistance in the development of the training for the DoD Components on the update of the initial program valuations and to provide assistance as required. The contract requires that the training plan include an adequate number of joint valuation updates to demonstrate that the Components understand the methodology and are capable of performing the updates. The Policy Office also recently added a full-time Government staff member to the training effort.

The Policy Office plans to provide a copy of the completed baseline valuations to the Component financial managers at the start of FY 2006 in a CAMS-ME test system. The test system would be available for training personnel for approximately 1 year. For Increment 1, the Policy Office had proposed training 25 Policy Office CAMS-ME end users. The Policy Office also needs to provide training for personnel representing approximately 1,000 programs and headquarters staff on policy and procedural changes and system operation for Increment 2. According to the Policy Office, they scheduled testing for Increment 2 of CAMS-ME in the third quarter of FY 2006. The Policy Office indicated that the testing schedule allows adequate time for training Service headquarters staff. However, the PMO staff, which may have to enter quantity information, would train using a training system because of the size of the group and the schedule.

Baseline Update Success

Because the Department does not have financial and accountability systems that provide accurate and timely information, the Policy Office depended largely on the Space and Naval Warfare Systems Center, DFAS, the PMOs, and the Financial Management Components of the Services to address the risks involved in updating the baseline value of military equipment.

However, given the challenges to acquire and implement a new system, the Policy Office may not have sufficient time to meet the September 30, 2006, baseline date.

If the Policy Office plans for developing the CAMS-ME Increment 1 are unsuccessful, it would have to either update and sustain the valuations manually or extend the military equipment valuation deadline.

Regardless of the methods used to update the asset acquisition cost and quantity data, the Policy Office will have approximately 3 months between the June 2006 “soft” or trial closing and the September 30, 2006, baseline report date to accomplish the update. This allows the Policy Office a very limited time during the fourth quarter to resolve issues identified during the trial closing.

Although the Policy Office indicated that the testing schedule of the new system allows sufficient time for training headquarters staff, if they delayed the development of CAMS-ME Increments 1 and 2, they would have to perform much of the training for the headquarters staff and the PMO staff on systems and processes that may not be fully developed or tested.

Management Actions

During the engagement, we prepared and submitted to the Policy Office, an issue paper that discussed the baseline valuation update. Since we provided management with the issue paper, management has experienced “down time” in project development and has revised the schedule for implementing the military equipment update methodology. Management’s revision to the program timeline does not change the requirements of the recommendations.

Recommendations, Management Comments, and Audit Response

Revised Recommendation. As a result of management comments, we revised Recommendation B.2.b. to clarify our intention that an audit trail external to the financial systems may also support the financial statements.

The Director, Acquisition Resources and Analysis provided comments on Recommendation B.1. that included comments from the Deputy Director of the Property and Equipment Policy Office. Comments on Recommendation B.2. included comments from the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

B.1. We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics:

a. Develop specific milestones in cooperation with the Space & Naval Warfare Systems Center, Defense Finance and Accounting Service, the

Program Management Offices, and the DoD Component Financial Management Offices that would address the risks involved in updating the baseline value of military equipment.

Management Comments. The Director concurred, stating that the Policy Office uses a comprehensive Project Management Plan with milestones to control and monitor each increment of the project. The Director stated that the Policy Office also has a plan that provides for communicating project status by reporting metrics and missed milestones and provides escalation procedures for addressing the causes of project delays.

b. Report to the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller/Chief Financial Officer) the status of the milestones on a recurring basis.

Management Comments. The Director concurred, stating Senior USD (AT&L) and the USD (Comptroller)/Chief Financial Officer officials receive periodic reports on project status. The Director stated that this project is one of the Comptroller's focus areas and is included in that comprehensive reporting process.

B.2. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller)/Chief Financial Officer:

a. Use the Property and Equipment Policy Office's status reports to assess whether the Department is likely to meet its goal of a military equipment baseline value, supported by an integrated system to update these values, by September 30, 2006.

Management Comments. The Director partially concurred, stating that nothing to date indicates the project will not meet its milestone dates as described in the Project Management Plan. She stated that the normal project risks exist and are reported on but do not provide sufficient reason to rebaseline the program. The Director stated that the Policy Office holds Project Management Plan status meetings with the internal management and delivery team and with representatives from the organizations involved in the military equipment valuation process. The Director further stated that the Executive Steering Group, which is composed of executive level representatives from the Military Departments' finance, acquisition, and logistics communities; DFAS; and the DoDIG, participates in status briefings on all aspects of the military equipment project.

Auditor Response. Although the Director only partially concurred with the recommendation, actions taken by the Policy Office satisfy the intent of the recommendation. Specifically, in the Management Actions Section of Finding B of this report, we state that during the engagement we prepared an issue paper that discussed updating the baseline valuation and submitting it to the Policy Office. Since we provided the issue paper, management has experienced "down time" in project development and has revised the schedule for implementing the military

equipment update methodology. Further, although the Director stated that nothing to date indicates the project will not meet its milestone dates, she acknowledged in her response to recommendation B.1.a, that the program risks could “require continuation of the manual baseline update process through 2006, an enormous and expensive undertaking.” No further comments are required.

b. Revise the baseline date until the Department has implemented a fully tested and integrated system, including the necessary interfaces and portals, that is capable of updating and sustaining the baseline value of military equipment or can otherwise adequately support the financial statements.

Management Comments. The Director nonconcurred, stating that the date for establishing the military equipment baseline is a Departmental goal and one of four focus areas for improving financial management. The Director further stated that this recommendation conflicts with the previous recommendation for the Department to assess whether it can meet the deadline. The Director acknowledged that integrated systems are necessary for the efficient accumulation of accurate military equipment information, but does not believe that full systems integration is required to achieve compliance with Federal accounting standards. The Director stated that DoD will have to rely on less than optimum techniques to meet its financial reporting objectives and for obtaining an opinion on military equipment information included in its annual financial statements. The Director stated that the recommendation is not in line with best practices or Federal policy. The Director stated that the incremental development approach of the CAMS-ME is in line with the Federal policy and best acquisition practices as each increment of CAMS-ME will be fully tested with the operational assessments and test and evaluation conducted by the Joint Interoperability Test Command.

Auditor Response. Although the Director nonconcurred with the recommendation, actions taken by the Policy Office satisfy the intent of the recommendation. Since we provided management with the issue paper on the baseline valuation update, management has experienced “down time” in project development and has revised the schedule for implementing the military equipment update methodology.

We disagree with management’s assertion that the audit recommendation to revise the baseline date is in conflict with the audit recommendation to review status reports for monitoring timely project completion. Both recommendations focus on the establishment of realistic timeframes to monitor project completion.

Further, the Director’s statement that the recommendation appears to take an all encompassing approach to system development is inaccurate. Our report and recommendation do not take exception to the incremental approach to system implementation. Instead, the recommendation would be better interpreted to agree with OMB Circular A-130, which supports the audit position to establish a realistic timeframe, that is, to assess whether the Department can meet its September 30, 2006, baseline date and revise if it cannot meet the date. It may take more time to “use components that can be fully tested or prototyped prior to

production,” but the Department should expect that the results would be more in line with the guidance the Director has referenced. No further comments are required.

C. Accounting for Modifications to Military Equipment

In its baseline valuation model, the methodology the Policy Office used to capitalize and depreciate modification costs was not in accordance with generally accepted accounting principles. The methodology averaged the cost of modifications across all of the planned end items and assumed that the PMOs had modified all items. In addition, the valuations capitalized and depreciated the modification beginning with the period the PMOs placed the first end item in service, which may not be the period in which the expenditure for the modification occurred. As a result, the baseline valuation model incorrectly estimated the net book value of military equipment programs with modifications.

Modification Capitalization and Depreciation Policy

SFFAS No. 6. SFFAS No. 6 requires that costs for modifications that either extend the useful life of existing general property, plant, and equipment or enlarge or improve its capacity be capitalized and depreciated or amortized over the remaining useful life of the associated general property, plant, and equipment.

SFFAS No. 6, as amended by SFFAS No. 23 permits the use of a composite or group depreciation methodology. The composite methodology as defined in SFFAS No. 23 is a method of calculating depreciation that applies a single average rate to a number of diverse assets that have dissimilar characteristics and services lives. The group methodology is a method of calculating depreciation that applies a single, average rate to a number of identical assets having similar characteristics and service lives.

DoD Financial Management Regulation. The DoD FMR, volume 4, chapter 6, states that modification costs should be individually capitalized and depreciated over the applicable DoD standard recovery period because DoD policy recognizes that the Department modifies substantially- or fully-depreciated assets.

Proposed Business Rule on Modifications, Modernizations, and Upgrades. The Policy Office's proposed business rule on modifications, modernizations, and upgrades (hereafter referred to as modifications) states that modification costs may be capitalized using either of the following methods.

- For modifications that extend the useful life of an end item, capitalize the full cost separately and depreciate the cost over the useful life of the modification.
- For modifications that enlarge or improve the capacity but do not extend its useful life, capitalize the cost by:

-
- Adding the modification cost to the end item’s net book value and depreciating the resulting cost over the remaining useful life of the end item; or
 - Capitalizing the modification as a separate item and depreciating the modification over the lesser of the life of the modification or the remaining useful life of the end item. When a modification is capitalized separately from an end item, the modification should be linked to the end item (parent-child relationship) in the property accountability system.

Modification Capitalization and Depreciation

Accounting Approaches. In accordance with generally accepted accounting principles, the DoD FMR, and the proposed business rule, we considered two possible approaches to accounting for modifications that enlarged or increased the capacity of an end item but did not extend its useful life. Those approaches were:

- Capitalization per end item, and
- Capitalization as a separate item.

Capitalization per End Item. Capitalizing cost per end item allocates the modification costs across all associated end items in service. This approach adds the modification costs to the net book value of the individual end item and depreciates the costs over the remaining useful life of the end item. This approach provides the most accurate reflection of historical cost and complies with SFFAS No. 6 and the proposed business rule on modifications.

Capitalization as a Separate Item. Modification cost capitalized as a separate item captures the modification costs and depreciates the cost over the lesser of the life of the modification or the average remaining useful lives of the related end items. This approach most closely agrees with the guidance in the DoD FMR.

Baseline Valuation Model. In contrast to SFFAS No. 6 and the DoD FMR, the baseline valuation model the Policy Office used first added the total modification costs as a single value to the program’s original acquisition costs in order to calculate the total estimated program cost. The baseline valuation model then calculated the estimated cost per end item by dividing the total estimated program cost by the number of planned end items. As a result, the cost of each end item included a portion of the modification costs, regardless of when the modifications occurred. Likewise, the baseline valuation model began depreciation of the modification cost when the PMOs placed the first end item in service, which may not have been the period in which the modification expenditure occurred.

Baseline Values

The baseline valuation method not only failed to comply with guidance, it resulted in an incorrect estimated net book value, and had the following additional drawbacks.

- Prior to the date of the actual modification expenditures, the estimated cost per end item and the depreciation expense were overstated because the model incorrectly spread the estimated costs and expenditures for modifications over all end items, including those that had not been modified. For example, the PMO first incurred modifications costs for the AH-1W Helicopter Program in FY 1996 with a cost of \$63,296,143. Although the program did not incur modification costs before FY 1996, the baseline valuation model incorrectly capitalized \$49,562,074 in cumulative modification costs and expensed \$7,882,161 in accumulated depreciations of FY 1995.
- Costs allocated to items disposed of prior to the actual expenditures caused the depreciation base and expense for disposed items to be overstated. As a result, the depreciation base and expense of all remaining end items were misstated.
- Work-in-process may have been miscalculated since the average estimated cost per end item incorrectly included the modification costs.

Management Actions

On April 8, 2005, the Deputy Director of the Property and Equipment Policy Office requested that the Services comment on the office's position paper titled, "Baseline Valuation Methodology Position Paper: Modifications, Modernizations, Upgrades, and Improvements." The Policy Office provided a copy of the position paper to us. The position paper proposed policy to account for modifications during the baseline valuation under the following three scenarios:

- Modifications that can be linked to specific end items,
- Modifications that can be linked to a specific program or programs, and
- Modifications that relate to a type of asset but the cost of the modification cannot be linked to specific assets or programs.

The Office of Inspector General has reviewed the revised policy and has provided comments. If the policy office accounts for modifications using the methodology discussed in its revised policy, it should adequately resolve the issues discussed in this finding. We will revisit this issue when the Department has implemented the revised policy.

Recommendation and Management Comments

C. We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics revise the baseline valuation methodology to use the capitalization per end item or capitalization as a separate item approach, or both, to capitalize and depreciate military equipment modifications.

Management Comments. The Director, Acquisition Resources and Analysis provided comments that included comments from the Deputy Director of the Property and Equipment Policy Office. The Director concurred, stating that the Policy Office revised the Military Equipment Modifications Policy Position Paper to address three scenarios: Modifications can be linked to specific end items; Modifications can be linked to a specific program or programs but not specific end items; and Modifications relate to a type of assets (such as ships), but the information is not available to link the cost of modifications to affected programs or specific end items.

D. Waivers to Military Equipment Valuation

The Policy Office methodology appropriately used a waiver process to exclude programs that did not meet the definition for military equipment. However, we could not verify the validity of 12 of the 29 waivers in our sample because the program managers did not include adequate supporting documentation to allow independent assessment. Without verifying the validity of the waivers, the Policy Office could not ensure that the military equipment universe included all valid programs and excluded all invalid programs. Further, depending on the validity of the waiver, the military equipment valuation on the financial statements could be overstated or understated.

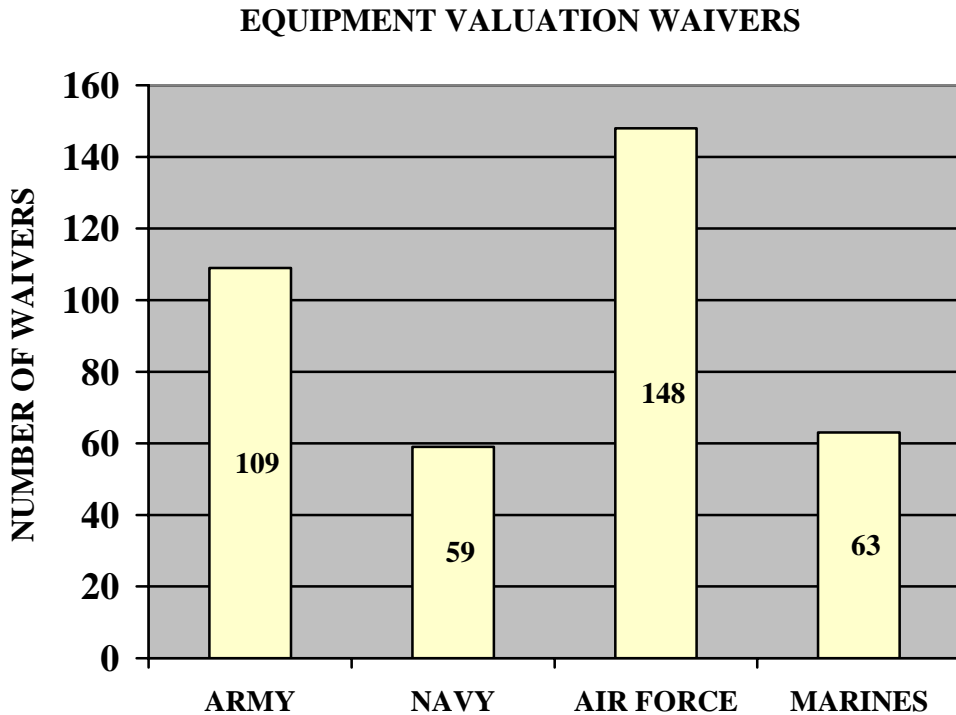
Policy on Omissions and Misstatements

Statement of Financial Accounting Concepts. Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, “Qualitative Characteristics of Accounting Information,” May 1980, states that an omission or misstatement of accounting information is material if that information, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Support for Waivers

Military Equipment Valuation Waivers. The Policy Office used the term “waiver” to define the intentional decision to exclude a potential military equipment program from valuation. Initially, the Policy Office identified all potential military equipment programs. As they obtained more knowledge about the programs, they excluded those that met the requirements for waiver from the process of valuing military equipment for the financial statements. As of November 30, 2004, the Policy Office had reviewed 456 programs. Of those 456 programs, the Policy Office had granted waivers for 255. The Policy Office classified those waivers by type as illustrated in the Table in Appendix D. In comparison, as of the same date, the number of military equipment programs that the Policy Office had valued totaled 201.

As of February 28, 2005, the Policy Office had completed 583 programs, with 379 of those programs or portions of the programs granted a waiver status. The following chart shows a breakdown of the 379 waivers by Service. The waiver total for the Army, Navy, Air Force, and Marines, was 109, 59, 148, and 63, respectively.



Waiver Verification. In our sample of 48 completed military equipment valuation programs and subprograms, the program managers had issued 29 waivers for programs and portions of programs. For 17 of the waivers, the program manager provided adequate documentation, which verified that those waivers were valid. However, 12 of the 29 waivers lacked sufficient support to allow an independent party or reasonable person to determine the validity of granting the waiver.

In particular, waiver supporting documentation appears to be deficient for “No Book Value” and “Software” waiver categories. The program manager did not provide an explanation for the lack of documentation. For the “No Book Value” waivers, DoD should have documented that it has fully depreciated the equipment. For the waivers relating to internal use software, DoD should have explained why it valued the software within the military equipment separately as internal use software, as opposed to military equipment, if DoD considered the software an integral part of the item. However, the general statement that the valuation followed Federal Accounting Standards Advisory Board Standard 10 was insufficient.

Waivers without Adequate Documentation

Type	No. of Waivers	Description
No Book Value	8	Program where the net book values of the end items is zero (e.g. fully depreciated)
Software	2	Program where SFFAS 10 applies and the end item is not considered military equipment.
Other	1	Program is a study program, in perpetual RDT&E,* or end item is not considered military equipment.
Temporary	1	Program is in the RDT&E stage.

*RDT&E (Research, Development, Test and Evaluation)

Waiver Effect

Without verifying the validity of the waivers, the Policy Office could not ensure that the military equipment universe included all valid programs and excluded all invalid programs. Further, depending on the validity of the waiver, DoD may overstate or understate the military equipment value on the financial statements. Specifically, if a military equipment program had erroneously been waived, then the military equipment program would not be valued and the military equipment line item of the financial statement would be understated. If the Policy Office had valued a military equipment program when it should have granted a waiver, then the military equipment line item of the financial statement would be overstated. Depending on the materiality of the omission or misstatement of military equipment accounting information related to a waiver, the omission or misstatement could change or influence the judgment of a reasonable person relying on the information. Consequently, the accuracy of the financial statement information would be directly dependent on the accuracy of the waiver.

Recommendation, Management Comments, and Audit Response

D. We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics take action to verify the validity of equipment valuation waivers before acceptance, and accept the waiver only if the program managers have provided adequate supporting documentation to allow independent verification.

Management Comments. The Director, Acquisition Resources and Analysis provided comments that included comments from the Deputy Director of the Property and Equipment Policy Office. The Director partially concurred, stating that because of the complexity of internal use software, her office and the PMO jointly reviewed program descriptions and determined whether to waive the programs. The Director stated that her office believes that this process was sufficient for verifying the validity of waivers for internal use software. The Director stated that for programs waived because the associated end item met the criteria for classification as “fully depreciated,” her office reviewed the latest placed-in-service dates provided by the PMO and accepted the waiver if the dates provided supported this determination. The Director stated that her office did not observe the supporting documentation in support of the placed-in-service date, but advised program managers of the need to maintain documentation in support of their waiver determination for subsequent independent verification.

Auditor Response. The Director’s comments are nonresponsive and do not address the two key areas of adequate supporting documentation and independent verification. Further, regarding internal use software, it is precisely because the area is complex that supporting documentation should be adequate and allow for independent verification. Regarding the “fully depreciated” category, the documentation should support the determination that a \$0 value assertion was appropriate. We request that the Director reconsider her position on supporting validity of waivers and provide comments on the final report.

E. Program Management Office Attestation

The Policy Office used a questionnaire that provided no assurance that the program manager supported the valuation amounts that the Policy Office had calculated for the military equipment programs. The questionnaire provided no assurance because the Policy Office did not require the program managers to sign an attestation to affirm their concurrence with the accuracy and validity of the military equipment valuation data for their program. In addition, any change in program management staff that supplied the data, might raise the issue of ownership and responsibility for the accuracy of the data used in the valuation. Without an attestation that establishes accountability for accuracy, the military equipment valuation amount may not be reliable.

Program Manager Assurance

The Policy Office developed a questionnaire that provided no assurance that the program manager supported the valuation amounts that the Policy Office had calculated for the military equipment programs. The Policy Office used the questionnaire to collect military equipment program data from the program office.

Data Collection. The questionnaire required the program office to provide responses to 99 questions. In addition, it required them to provide the name and contact information for the program manager and a point of contact. As part of the data collection process, representatives of the Policy Office and their contractor, KPMG, would meet with personnel from each program to provide an overview of the military equipment valuation project, review the data questionnaire in depth, and answer questions. Tasking the program manager to complete the entire questionnaire would require the program manager or his staff to devote time to the program valuation project and might limit their ability to perform their regularly assigned tasks. Consequently, the Policy Office stated that they would populate the questionnaire with all available data before meeting with program office personnel to minimize the impact of the data collection effort. In addition, the general instructions for the program questionnaire included the following statement: “This data collection instrument will be pre-populated to the extent information is available prior to the team conducting a Program Office in-brief on the Military Equipment Valuation Project.”

Responsibility and Ownership of Data. Responsibility and ownership of the program data the program offices provided for the military equipment valuation was not always clear. In addition, any change in program management staff that supplied the data, would raise the issue of who was responsible for the accuracy of the data used in the valuation.

Attestation Concurrence

The Policy Office had not required the program managers to sign an attestation to affirm their concurrence with the accuracy and validity of the military equipment valuation data for their program. At the time of our audit fieldwork in November 2004, the Policy Office had completed a total of 456 programs without an attestation.

When the Policy Office clarifies the accountability for the data and requires the responsible party to attest to the accuracy and validity of the information, the clarification might improve the accuracy and validity of the information. The underlying assumption is that a program manager would not want the reviewer to hold them accountable for data that is not accurate and valid. Therefore, the program manager will expend the necessary time and effort to ensure the accuracy of the data.

Conclusion

Without accountability, the military equipment valuation amount may not be as reliable as a military equipment valuation amount with an attestation. The requirement to prepare an attestation implies that there will be more scrutiny of the data before the program manager will provide his concurrence. A signed attestation is a relatively low-cost effort that will increase the likelihood that the data will be accurate and valid.

Management Actions

During the engagement, we discussed the attestation issue with the Policy Office. The Policy Office acknowledged the validity of our concern and subsequently revised the methodology to include a program management attestation. However, the revised methodology did not include an attestation to confirm the *actual amount* at which the program was valued. The memorandum included the following statement:

We affirm that we have provided all available and known documents in support of deriving the military equipment values for the We further understand that we will be responsible for defending the military equipment values assessed based on the supporting documentation we provided.

Affirming the availability of documents and defending the military equipment values based on the supporting document is not the same as agreeing to the accuracy and validity of the valuation amount for the program. Specifically, if the pre-populated questionnaire, the calculations, or the documents contain errors, the valuation may be incorrect but adequately documented. The attestation should affirm concurrence with the accuracy and validity of the military equipment valuation amount for the program.

Recommendation, Management Comments, and Audit Response

E. We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics require program managers to sign an attestation to affirm their concurrence with the accuracy and validity of the military equipment valuation amount for their program.

Management Comments. The Director, Acquisition Resources and Analysis provided comments that included comments from the Deputy Director of the Property and Equipment Policy Office. The Director partially concurred, stating that for program valuations completed before December 31, 2004, her office obtained program manager verbal concurrence with the accuracy of the information. She stated that for program valuations completed after December 31, 2004, her office obtained program manager written concurrence with the accuracy of the information. The Director stated that her office believes that because the program managers provided the information for the military equipment valuation, they should assert to that information rather than attest to its accuracy. The Director stated that program managers change over the life of a program and current program managers are limited in their ability to assert to amounts representing transactions that occurred prior to their tenure.

Auditor Response. The Director's comments are nonresponsive. Although the Director stated that she had obtained "verbal concurrence" from program managers in reference to the accuracy of information provided for programs valued prior to December 31, 2004, that method of concurrence does not provide an audit trail. In addition, as stated in the Management Actions section of finding E, affirming the availability of documents and defending the military equipment values based on the supporting document is not the same as agreeing to the accuracy and validity of the military equipment valuation amount for the program. An attestation should affirm concurrence with the accuracy and validity of the military equipment valuation amount for the program. Further, it is because program managers change over the life of the program, that the attestation is so important. We request that the Director reconsider her position on obtaining signed attestations as to the accuracy of the information provided by program managers, and provide comments on the final report.

Appendix A. Scope and Methodology

We reviewed the Policy Office baseline valuation methodology to develop a complete military equipment universe, calculate program valuations, and appropriately assign waivers. Specifically, we reviewed the reasonableness and reliability of the numerous sources used to develop the military equipment universe that had expanded to 1,074 programs as of February 28, 2005. We reviewed the reasonableness of the valuation model, the approach the Policy Office used to obtain and incorporate data elements, including the proposed baseline update solution, and the 10 Policy Office-proposed business rules, which they used as a basis for the valuations. We reviewed the waiver criteria that the Policy Office used to exclude programs from valuations. We held discussions with key personnel from the Policy Office and its contractor, KPMG, and attended program review debriefings conducted by KPMG with some PMOs.

We judgmentally selected and reviewed 16 of the 326 programs that KPMG had reviewed as of August 27, 2004. We later judgmentally selected and reviewed six additional programs from one of our site visits that occurred in September 2004. Therefore, in total we judgmentally selected and reviewed 22 programs. To facilitate their program valuations, KPMG had further divided programs, when possible, into a subset of subprograms. KPMG would then calculate the valuations and grant waivers on a subprogram level. Therefore, in some instances a single program had multiple subprogram valuations and multiple subprogram waivers. Of the 22 programs we judgmentally selected, 8 were further divided into subprograms. As a result, we reviewed a total of 48 programs and subprograms. Of the 48 programs and subprograms, the Policy Office had completed a valuation for 19 and granted waivers for 29. The Office of Inspector General with the assistance of the Government Accountability Office reviewed the reasonableness and consistency of the 19 valuations and related supporting documentation. Specifically, we examined valuation acquisition and disposal dates, useful lives, total estimated program costs through FY 2006, and total estimated expenditures through the valuation completion date. We reviewed the reasonableness and consistency of the 29 waivers and related supporting documentation.

Scope Limitations. We performed this audit from October 2004 through March 2005 in accordance with generally accepted government auditing standards. Our scope was limited to agreed-upon procedures that did not include tests of management controls. Therefore, we limited our scope and judgmentally selected and reviewed 48 programs and subprograms to evaluate the effectiveness of the proposed methodology to value military equipment. During the program and methodology reviews we identified process deficiencies and provided three issue papers to the Policy Office.

Use of Computer-Processed Data. We relied on computer-processed data provided directly from the Policy Office and KPMG that was extracted from numerous DoD financial, acquisition, and logistics systems to evaluate sample program valuations and waivers. Specifically, we used the computer-processed data to review program valuation calculations, determine supporting

documentation inadequacies, and analyze waiver appropriateness. We did not determine the reliability of the computer-processed data.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Financial Management high-risk area.

Appendix B. Prior Coverage

During the last 5 years, the Government Accountability Office (GAO), the Department of Defense Inspector General (DoD IG), and U.S. Army Audit Agency have issued eight reports discussing military equipment. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted DoD IG reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

GAO

Report No. GAO 04-910R, “Financial Management: Further Actions Are Needed to Establish Framework to Guide Audit Opinion and Business Management Improvement Efforts at DoD,” September 20, 2004

Report No. GAO 04-615, “DoD Business Systems Modernization: Billions Continue to Be Invested with Inadequate Management Oversight and Accountability,” May 2004

DoD IG

DoD IG Report No. D-2004-092, “Corps of Engineers Equipment Reporting on Financial Statements for FY 2003,” June 22, 2004

DoD IG Report No. D-2003-117, “Systems Inventory to Support the Business Enterprise Architecture,” July 10, 2003

DoD IG Report No. D-2001-011, “Prior Period Adjustment to Remove National Defense Property, Plant, and Equipment,” November 16, 2000

Army

U.S. Army Audit Agency Report No. A-2003-0139 “National Defense Equipment Reporting,” February 6, 2003

U.S. Army Audit Agency Report No. A-2002-0238-FFG “Audit of The Army’s FY 01 General Fund Financial Statements-General Equipment,” March 13, 2002

U.S. Army Audit Agency Report No. AA-2001-225, “Audit of the Army’s Inventory and Control of Military Equipment,” April 6, 2001

Appendix C. Glossary of Technical Terms

363 Report. The 363 Report is a compilation of individual Military Service reports reflecting the inventory of major end items of military equipment, as required by the National Defense Authorization Act for Fiscal Year 2000, Public Law 106-65, Section 363. The Law required this report as of September 30, 1999.

Accountability System. The accountability system is primarily used by logisticians to track military equipment and products. The system may also track the condition and location of each item.

Business Enterprise Architecture. A blueprint to guide and constrain investments within DoD organizations, operations, and systems as they relate to or impact business operations. Information Technology (IT) will provide the basis for the planning, development, and implementation of business management systems that comply with Federal mandates and requirements, resulting in accurate, reliable, timely, and compliant information for DoD staff.

CAMS-ME. The Capital Asset Management System-Military Equipment is a business system responding to business opportunities, not warfighting threats. The capability would operate in a business environment tied to contract award production, end item receipt and acceptance, and personal property administration.

Capitalization. The Statement of Federal Financial Accounting Statement No. 23 requires the capitalization and depreciation of all property, plant and equipment designated as military equipment and meeting certain criteria. The criteria are as follows: (1) useful life exceeding 2 years, (2) not intended for sale, and (3) exceeds capitalization threshold (in DoD, that threshold is \$100,000).

End Item. Final combinations of component parts or materials that is ready for its intended use (e.g., ship, tank, aircraft, mobile machine shop, etc.). For the purpose of this document, an end item is synonymous with asset.

Enterprise Architecture. Enterprise architecture is the explicit description and documentation of the current and desired relationship among business and management processes and information technology. The enterprise architecture describes the “current architecture” and “target architecture” and provides a strategy that will enable an agency to transition from its current state to its target environment.

Expenditure. An expenditure is a charge against available funds evidenced by voucher, claim, or other document approved by a competent authority. Expenditure represents the actual payment of funds.

GAO Defense Acquisitions: Assessments of Major Weapon Programs. GAO’s goal for issuing the report, “GAO Defense Acquisitions: Assessments of Major Weapon Programs,” is to provide Congressional and DoD decision makers with an independent, knowledge-based assessment of selected defense programs that identifies potential risks

and offers an opportunity for action when a program's objectives deviate from the best practice. The report can also highlight those programs that employ practices worthy of emulation by other programs. GAO plans to update and issue this report annually.

Government-Furnished Material. Government-furnished material is Government property which may be incorporated into or attached to an end item to be delivered under a contract or which may be consumed in the performance of a contract. It includes raw and processed material parts, components, assemblies, and small tools and supplies.

Government-Furnished Property. Government-furnished property is acquired directly by the Government and subsequently made available to the contractor.

Improvement. An improvement is a program enhancement that increases the future service potential of the asset and should be capitalized. Improvements include expenditures for a physical improvement to an existing capital asset such as additions and major alterations that are intended to improve performance or increase useful life.

Legacy Systems. Legacy systems are those database systems in existence and either deployed or under development at the start of a modernization program. All legacy systems would be affected by modernization to a greater or lesser extent. Some systems become transition systems before they are retired.

Midterm Solution. The midterm solution is a proposed system approach for the valuation of military equipment. The midterm solution leverages existing systems and processes to maintain the baseline valuations, manage the work-in-process account, and calculate the costs for military equipment acquired after September 30, 2006.

Military Equipment. Military equipment consists of tangible assets that are owned by DoD Components and meet the following criteria: (1) have an estimated useful life of 2 or more years, (2) are not intended for sale, and (3) are intended to be used or available for use by DoD Components in the performance of military missions to include equipment used in training for such missions. Included are certain assets that are components of weapons systems (e.g., aircraft pods) and assets that support that system (e.g., flight line equipment).

Modification. A modification is a change to a descriptive and governing characteristic of an item.

P-1 Budget Report. The P-1 Budget Report is provided annually to the DoD oversight committee of the Congress coinciding with transmittal of the President's Budget. The P-1 line items represent funding for active procurement programs per budget year.

Program. A program is: (1) A defined effort funded by research, development, test, and evaluation or procurement appropriations with the express objective of providing a new or improved capability in response to a stated mission need or deficiency. (2) A major, independent part of a software system. (3) A combination of program elements designed to express the accomplishment of a definite objective or plan.

Select Acquisition Report. A Select Acquisition Report is a standard, comprehensive, summary status report on major defense acquisition programs, acquisition category 1, required for periodic submission to the Congress. It includes key cost, schedule, and technical information.

Work-in-Process. Work-in-process refers to products that are being manufactured or fabricated but are not yet complete. It consists of the costs of direct materials, direct labor, direct purchased services, and indirect costs, including general and administrative costs, used in producing an end item.

Simplified Acquisition Threshold. For DoD, the simplified acquisition threshold refers to the \$100,000 threshold, except for acquisitions of supplies or services that, as determined by the head of the agency, are to be used to support a contingency operation or to facilitate defense against or recovery from nuclear, biological, chemical, or radiological attack.

Appendix D. Waiver Types

Waiver Types and Quantities as of November 30, 2004

Code	Type	No. of Waivers	Description
C	Classified	1	Program where details on funding, end items, etc. cannot be obtained.
D	Deactivated	10	Program's end items are anticipated to be fully deactivated by 9/30/06.
E	Entity	8	End items produced would be reported by another entity, because of funding or predominance of use.
F	FMS	5	Program is entirely foreign military sales.
L	Life	6	Useful life is estimated at less than 2 years.
N	No Book Value	33	Program where the net book value of the end items is zero (e.g. fully depreciated).
O	Other	32	Program is a study in perpetual RDT&E or end item is not considered military equipment.
P	Price	53	Program where the cost per end item is less than the capitalization threshold of \$100,000.
R	Real Property	1	Program is considered to be real property/infrastructure under SFFAS 6.
S	Software	34	Program where SFFAS 10 applies and the end item is not considered military equipment.
T	Temporary	53	Program is in the RDT&E stage.
None	Multiple	19	Programs with two or more of the identified codes.

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Director, Acquisition Resources and Analysis
Deputy Director, Property and Equipment Policy Office
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

Other Defense Organizations

Director, Defense Finance and Accounting Service

Non-Defense Federal Organization

Government Accountability Office

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 Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (cont'd)

House Committee on Armed Services

House Committee on Government Reform

House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform

House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform

House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics Comments



ACQUISITION
TECHNOLOGY
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

JUL 14 2005

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, DEFENSE
FINANCIAL AUDITING SERVICE

SUBJECT: Response to Draft Report on the Development of the DoD Baseline for
Military Equipment (Project No. D2005FH-033.001)

The following is in response to the subject report.

General Content:

The draft report contains many important recommendations, many of which were in place or in the process of implementation at the conclusion of the DoD Inspector General's (DoDIG) project. We do not concur with certain recommendations and provided clarification to others.

Recommendations:

A. Support for Military Equipment Valuations

DoDIG Recommendation A.1: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics: Determine the availability of documentation to support the valuation.

Response: Concur. Paragraph 10 of Statement of Federal Financial Accounting Standards (SFFAS) Number (No.) 23 provides that "The initial capitalization amount for assets previously considered [National Defense Property, Plant and Equipment] should be based on historical cost in accordance with the asset recognition provisions of SFFAS No. 6, as amended, and should be the initial historical cost for the items, including any major improvements or modifications."

Paragraph 12 of SFFAS No. 23 provides that "If obtaining initial historical cost is not practical, estimated historical cost may be used. Other information such as but not limited to budget, appropriation, or engineering documents and other reports reflecting amounts expended may be used as the basis for estimating historical cost."



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At the inception of the military equipment valuation project, the Property and Equipment (P&E) Policy Office concluded that given the number of military equipment programs subject to baseline valuation and the age of the majority of these programs, it would be impractical if not impossible to accumulate the documents necessary to support the valuation of all program costs.

For recently initiated programs, determining the availability of supporting documentation involves a multi-step process. We first have to define the documents required to support the baseline valuations. We then have to determine the availability of these documents.

Working with selected Program Management Offices and the Defense Finance and Accounting Service (DFAS), and other organizations as necessary, the P&E Policy Office will define appropriate supporting documentation, (e.g., contract documents, delivery documents, payment requests, disposal documents, etc.). Next, we will determine the availability of appropriate supporting documentation and whether it is practical to accumulate the information to support transactions that occurred after the standard's effective date. Finally, we will provide a document accumulation, review, and retention guide to facilitate the process in programs where the appropriate supporting documentation is available and it is practical to gather this information.

For post baseline activity, we will establish a document accumulation and retention regime that provides for the timely assessment of whether military equipment is reported in accordance with standards.

DoDIG Recommendation A.2: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics: Use available historical cost supporting documentation in its methodology to value military equipment and use other source documentation only when historical cost supporting documentation is not available and not practical to obtain.

Response: Partially concur. The DoDIG recommendation indicates that it is appropriate to use other source documentation only when historical cost supporting documentation is not available and not practical to obtain. For clarification, SFFAS No. 23 provides for the use of alternative data sources "If obtaining initial historical cost is not practical, estimated historical cost may be used."

As noted above in our response to recommendation A.1, after we define appropriate supporting documentation, we will determine the availability of appropriate supporting documentation and whether it is practical to accumulate the information to support transactions that occurred after the standard's effective date.

Revised

DoDIG Recommendation A.3: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics: Disclose in the financial statement notes that DoD did not comply with the requirements of SFFAS No. 23, if DoD uses estimates in lieu of actual historical cost information.

Response: Non-concur. The P&E Policy Office does not concur with the recommendation to disclose non-compliance with the provisions of SFFAS No. 23 if it uses estimates in reporting the military equipment baseline. Given the provisions of SFFAS No. 23 cited above, we are of the opinion that our methodology for valuing programs discussed above is in full compliance with this standard.

B. Updates to the Military Equipment Baseline

DoDIG Recommendation B.1.a: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics: Develop specific milestones in cooperation with the Space and Naval Warfare Systems Center, Defense Finance and Accounting Service, the Program Management Offices, and the DoD Component Financial Management Offices that would address the risks involved in updating the baseline value of military equipment.

Response: Concur. As acknowledged in the DoDIG draft report, the P&E Policy Office has an incremental systems development, implementation, and training plan for automating the post baseline military equipment valuation process.

The P&E Policy uses a comprehensive Project Management Plan with milestones to control and monitor each increment of the project. The Project Management Plan has over 100 milestones, 11 of which are considered critical. The P&E Policy Office also has a plan that provides for communicating project status through metric reporting. This latter plan also addresses reporting of missed milestones and provides escalation procedures for addressing the causes of project delays.

The other organizations involved in project (e.g., Space and Naval Warfare Systems Command (SPAWAR)) have developed project plans for their specific tasks. Status against the milestones is reported weekly and discussed between all the organizations involved in the development effort. The Components are in turn developing their Financial Improvement and Audit Readiness plans, which cover the actions they are taking to implement the Standard.

The P&E Policy Office acknowledges the risks associated with each of the increments. Increment 1 risks include delays associated with hardware acquisition and

completion of required interfaces with the DFAS Corporate Database/Corporate Warehouse (DCD/DCW), both of which would require continuation of the manual baseline update process through 2006, an enormous and expensive undertaking. Increment 2 risks include delays in implementing changes to business process resulting in data limitations. This will prohibit the automated calculation of military equipment values at the contract level resulting in the need to continue the manual update process in the post fiscal year 2006 period. Increment 3 risks include accountability system limitations that will preclude the maintenance of baseline and accounting for future transactions in a manner that facilitates compliance with accounting standards.

DoDIG Recommendation B.1.b: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics: Report to the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller/Chief Financial Officer) the status of the milestones on a recurring basis

Response: Concur. Senior OUSD (AT&L) and OUSD (C) officials receive periodic reports on project status in the context of the 11 critical milestones through a formal project reporting mechanism. This project is one of the Comptroller's focus areas and is included in that comprehensive reporting process as well.

DoDIG Recommendation B.2.a: We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller/Chief Financial Officer): Use the P&E Policy Office's status reports to assess whether the Department is likely to meet its goal of a military equipment baseline value, supported by the integrated systems to update these values by September 30, 2006.

Response: Partially Concur. Nothing to date that indicates the project will not meet its milestone dates as described in the Project Management Plan. Risks exist and are reported on but this is normal for any project that the Department undertakes but is not sufficient reason to rebaseline the program

An assessment of the project's progress is part of the normal program management and milestone reviews and P&E Policy's regular updates to senior management. The P&E Policy Office holds Project Management Plan status meetings with the internal management and delivery team and with representatives from DFAS, SPAWAR, and the Military Departments. The Office uses a web based tool to track milestones, issues, and risks, which is updated at the conclusion of each management and delivery team meeting. The Office manages issue resolution status through its weekly conference call with members of the foregoing organizations.

The P&E Policy Office created the Executive Steering Group (ESG), which is comprised of executive level representatives from the Military Departments' finance,

acquisition, and logistics communities, DFAS, and the DoDIG. This group meets quarterly, or as required, and its members are the executive level points of contact with other parts of their respective organizations. The ESG participates in status briefings on all aspects of the military equipment project, including current and emerging issues requiring their attention. They provide advice and counsel for P&E Policy Office leadership consideration.

DoDIG Recommendation B.2.b: We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Under Secretary of Defense (Comptroller/Chief Financial Officer): Revise the baseline date until the Department has implemented a fully tested and integrated system, including the necessary interfaces and portals, that is capable of updating and sustaining the baseline value of military equipment.

Response: Non-concur. The date for establishing the military equipment baseline is a Departmental goal and one of four focus areas for improving financial management. This date is a target goal based on currently planned actions. Additionally, this recommendation conflicts with the previous recommendation for the Department to assess whether the deadline can be met.

With respect to systems integration, the P&E Policy Office acknowledges that integrated systems are necessary for the efficient accumulation of accurate military equipment information. However, we do not believe that full systems integration is required to achieve compliance with Federal accounting standards. Given the timeline required to acquire and implement new systems, DoD will have to rely on less than optimum techniques to meet its financial reporting objectives and for obtaining an opinion on military equipment information included in its annual financial statements.

The recommendation also appears to take an all encompassing approach to system development, which is not in line with best practices or federal policy. For example:

Office of Management and Budget (OMB) Memorandum M-97-02, Funding Information Systems Investments (October 25, 1996, requires that systems “be implemented in phased, successive chunks as narrow in scope and brief in duration as practicable, each of which solves a specific part of an overall mission problem and delivers a measurable net benefit independent of future chunks.”

OMB Circular A-130, Transmittal Memorandum #4, Management of Federal Information Resources (11/28/2000) states that agencies should “Reduce risk by avoiding or isolating custom designed components, using components that can be fully tested or prototyped prior to production, and ensuring involvement and support of users.”

The incremental development approach of the Capital Asset Management System-Military Equipment (CAMS-ME) is in line with the OMB requirements and best acquisition practices. Each increment of CAM-ME will be fully tested with the operational assessments and test and evaluation conducted by the Joint Interoperability Test Command (JITC). To do otherwise would impose greater risk on the project than any risks identified in the draft report.

C. Accounting for Modifications to Military Equipment.

DoDIG Recommendation: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics revise the baseline valuation methodology to use the capitalization per end item or capitalization as a separate item approach, or both, for capitalizing and depreciating military equipment modifications.

Response: Concur. The P&E Policy Office revised the Military Equipment Modifications Policy Position Paper as follows:

The proposed policy for baseline valuations addresses the following three scenarios: (1) Modifications can be linked to specific end items; (2) Modifications can be linked to a specific program or programs but not specific end items; and (3) Modifications relate to a type of assets (such as ships), but the information is not available to link the cost of the modifications to affected programs or specific end items.

Modifications that can be linked to specific end items will be treated as follows: (a) Modification that extend the useful life of an end item - capitalize the cost of modifications as part of the cost of the end item and depreciate over the end item's new useful life; (b) Modifications that enlarge or improve the capacity of the end items, but do not extend the end items' useful life - capitalize the cost of the modifications as part of the cost of the end items and depreciate over the end items' remaining useful life; and (c) Write off (recognize as a loss) the net book value of the end and modification at the time of end item disposition.

Modifications that can be linked to a specific program or programs but not specific end items will be treated as follows: (a) Capitalize the modification costs incurred during a given fiscal year as a separate item and depreciate over the estimated useful life of the modification; (b) Develop an estimate of the portion of these modification costs allocable to end items in service at the end of the fiscal year in which the modification costs were incurred; (c) Associate the capitalized modification costs with the end items in service at the end of the year in which the modification costs were incurred through a parent-child relationship; and (d) Write

off (recognize as a loss) the net book value of the end item and associated estimated modification costs at the time of end item disposition.¹

Modifications that cannot be linked to specific programs or end items will be treated as follows: (a) Capitalize the modification costs incurred during a given fiscal year as a separate item and depreciate over the estimated useful life of the modification; and (b) For baseline valuation, because modification costs cannot be associated with a program or programs or specific end items, no provision is made for the write off of a portion of this account balance upon disposal of the related but unknown end item.

D. Waivers to Military Equipment Valuation

DoDIG Recommendation: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics take action to verify the validity of equipment valuation waivers before acceptance, and accept the waiver only if the program managers have provided adequate supporting documentation to allow independent verification.

Response: Partially concur. The DoDIG draft report specifically addressed two waiver areas: internal use software and fully depreciated end items.

With respect to internal use software, due to the complexity of the subject matter, we jointly reviewed with the Program Management Office the program description and made a determination of whether the program should be waived and, accordingly, accounted for pursuant to the provisions of SFFAS No. 10, *Accounting for Internal Use Software*. We believe this process was sufficient for verifying the validity of waivers for internal use software.

With respect to programs waived because the associated end items met the criteria for classification as “fully depreciated”, we reviewed the last date placed in service information provided by the Program Management Office and accepted the waiver if the dates provided supported this determination. We did not observe the supporting documentation in support of the “placed in service” date that formed the basis for a conclusion about whether the program end items are fully depreciated. We advised Program Managers of the need to maintain documentation in support of their waiver determination for subsequent independent verification.

¹ To illustrate, assume the following: (1) the entity incurred modifications costs of \$100,000,000 in 1998; (2) modifications had a useful life of 10 years; (3) the entity uses straight line depreciation; (4) the modifications affected 1000 end items in service; and (5) the destruction of 100 end items in 2001. At the end of 2001 the net book value of the modifications related to destroyed end items was \$7,000,000 (\$100,000,000 book value less \$30,000,000 accumulated depreciation equals \$70,000,000 net book value. Destroyed end items equal 10% of total end items or 10% of net book value - \$7,000,000)

With respect to information provided for the valuation process generally, including waivers, Program Managers and others are responsible for its reliability and for maintaining supporting documentation. We do not believe that it is necessary to validate this information prior to completing a program valuation or accepting a waiver determination.

However, we do believe documentation and retention guidance is necessary. Accordingly, as part of our document accumulation, review, and retention guidance discussed in our response to recommendation A.1., we will include guidance for retaining documents in support of waiver determinations. This will provide a basis for timely independent verification.

In addition, our proposed assertion process, discussed in the response to recommendation E.1., provides for a Program Manager assertion on various components of the valuation model. We will consider adding an assertion on waivers to this process, which supports the completeness assertion.

D. Program Management Office Attestation.

DoDIG Recommendation: We recommend that the Deputy Director of the Property and Equipment Policy Office in the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics require Program Managers to affirm their concurrence with the accuracy and validity of the military equipment valuation amount for their program.

Response: Partially concur. For program valuations completed before December 31, 2004, at the conclusion of the valuation process we obtained Program Manager verbal concurrence with the accuracy of the information for which the Program Management Office was responsible. For program valuations completed since December 31, 2004, we obtained Program Manager written concurrence with the accuracy of the information for which the Program Management Office was responsible.

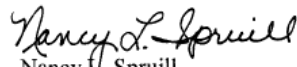
With respect to Program Manager concurrence generally, we are of the opinion that Program Managers should assert to the information provided rather than attest to its accuracy. It is their information; they provided the P&E Policy Office with the information for military equipment valuation purposes.

Given that Program Managers change over the life of a program, current Program Managers are limited in their ability to assert to amounts representing transactions that occurred prior to their tenure. With that in mind, the P&E Policy Office developed a prototype assertion model that, if adopted, would require Program Managers to provide an assertion that, to the best of their knowledge and belief, the information contained in the baseline valuation binders for their respective programs represents all programs

administered by their office; all items delivered (placed in service) under the program; the expenditures through (date) under the program; total estimated program costs; and total planned number of end items to be delivered under the program.

To facilitate the assertion process, the P&E Policy Office will provide each Program Management Office with the following: (a) Summary schedule and binders showing all known programs administered by PMO; (b) Summary schedule and binders listing items delivered (placed in service); (c) Summary schedule and binders listing expenditure data to date; (d) Summary schedule and binders showing total estimated program costs; (e) Summary schedule and binders showing planned number of end items; and (f) Baseline cost accumulation data tied to reports and accounting systems data from which derived.

If you have any questions about this memorandum, please contact Mr. Richard Sylvester, Deputy Director (ARA), Property and Equipment Policy Office, at (703) 604-6350 or Richard.Sylvester@osd.mil.


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