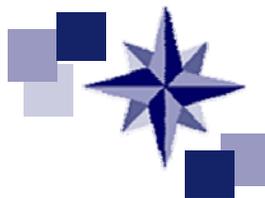


**Department of Defense
Office of the Inspector General**



**Financial Statement Audit
Fiscal Year 2008**

Submitted by



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Management Discussion and Analysis

I. Background

The Inspector General Act of 1978 established civilian Offices of Inspectors General in six cabinet-level Federal Departments and in an additional six Federal Agencies. Although Inspectors General have been a part of the Armed Forces since the American Revolutionary War, the Department of Defense, Office of Inspector General (DoD OIG) was not established until 1982 when Congress amended the Inspector General Act in the National Defense Authorization Act for Fiscal Year 1983 (P.L. 97-252, September 8, 1982).

Pursuant to the Inspector General Act of 1978, as amended, "the Inspector General of the Department of Defense shall . . . be the principal adviser to the Secretary of Defense for matters relating to the prevention of fraud, waste, and abuse in the programs and operations of the Department." The law also requires the Inspector General "to keep the [Secretary of Defense] and the Congress fully and currently informed . . . concerning fraud and other serious problems, abuses, and deficiencies" In carrying out all of the other statutory duties, the Inspector General of the Department of Defense is obligated by law to "give particular regard to the activities of the Government Accountability Office with a view towards avoiding duplication and insuring effective coordination and cooperation." Similarly, the Inspector General Act also requires the Office of the Inspector General to give "particular regard to the activities of the internal audit, inspection, and investigative units of the military departments with a view towards avoiding duplication and insuring effective coordination and cooperation."

II. Mission Statement

The mission of the DoD OIG is to promote integrity, accountability, and improvement of Department of Defense personnel, programs, and operations in order to support the Department's mission and serve the public interest.

III. Vision Statement

The DoD OIG's vision is one professional team strengthening the integrity, efficiency, and effectiveness of the Department of Defense.

IV. Core Values

The core values of the DoD OIG are accountability, integrity, and efficiency.

V. Organization

The DoD OIG audits, investigates, inspects, and evaluates programs and operations of the DoD and, as a result, recommends policies and process improvements that promote economy, efficiency, and effectiveness in DoD programs and operations. For the last 3 years, the DoD OIG has achieved \$22.4 billion in savings and \$4.3 billion in recoveries for the nation. The Inspector General (IG) is the only DoD official authorized to issue an opinion on the consolidated financial statements of the DoD.

The Inspector General also: ¹

- is the principal adviser to the Secretary of Defense (SECDEF) for matters relating to the prevention and detection of fraud, waste, and abuse in the DoD programs and operations;
- provides policy direction for audits and investigations relating to fraud, waste, and abuse and program effectiveness;
- investigates fraud, waste, and abuse uncovered as a result of other contract and internal audits, as the Inspector General considers appropriate;
- develops policy, monitors, and evaluates program performance, and provides guidance with respect to all Department activities relating to criminal investigation programs;
- monitors and evaluates the adherence of DoD auditors to internal audit, contract audit, and internal review principles, policies, and procedures;
- develops policy, evaluates program performance, and monitors actions of audits conducted by the Comptroller General of the United States;
- requests assistance as needed from other audit, inspection, and investigative units of the DoD (including Military Departments);
- gives particular regard to the activities of the internal audit, inspection, and investigative units of the Military Departments with a view toward avoiding duplication and ensuring effective coordination and cooperation; and
- reviews existing and proposed legislation and regulations relating to programs and operations of the DoD.

¹ IG Act, as amended,

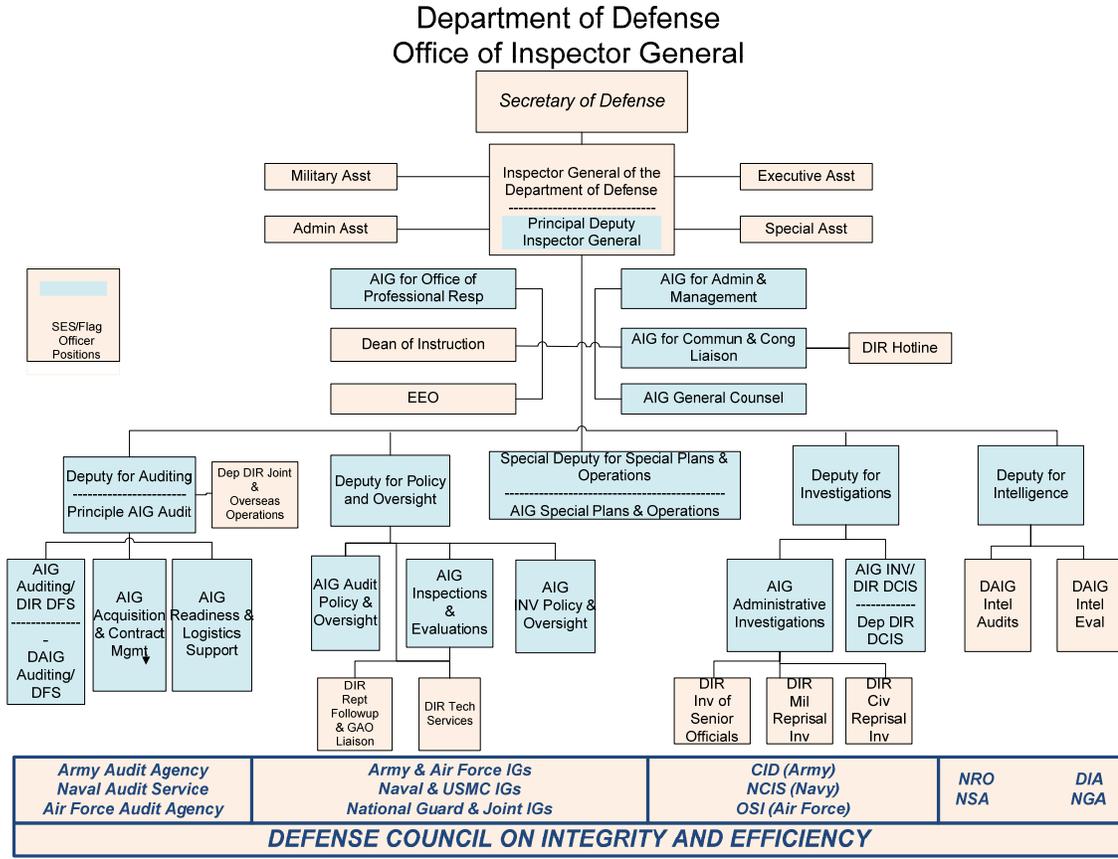


Figure 1. DoD OIG’s Organizational Structure as of September 30, 2008

A key tenet of the DoD OIG’s strategy is to link resources to achieve mission-based results. The DoD OIG accomplishes its mission through component agencies and offices that administer various statutes and programs on behalf of the Department.

Auditing

Section 3 (d) of the Inspector General Act of 1978 establishes the requirement for the audit function within the DoD OIG. The work of the Office of the Deputy Inspector General for Auditing (ODIG-AUD) results in recommendations for reducing costs; eliminating fraud, waste, and abuse; improving performance of business operations; strengthening internal controls; improving Military Service member effectiveness or safety; and achieving compliance with laws, regulations, and policies. Audit topics are determined by law, requests from the SECDEF and other DoD leadership, DoD hotline allegations, congressional requests, and DoD OIG risk analyses of DoD programs and also include areas of concern for contract pricing, services contracts, contractor overhead costs, and major weapons systems acquisitions. To support the Global War on Terror (GWOT), ODIG-AUD maintains staff in Iraq, Afghanistan and Qatar.

Investigations

The Office of the Deputy Inspector General for Investigations (ODIG-INV) comprises the Defense Criminal Investigative Service (DCIS) and the Office of the Assistant Inspector General for Administrative Investigations, the latter consisting of Investigations of Senior Officials (ISO), Military Reprisal Investigations (MRI), and Civilian Reprisal Investigations (CRI).

ODIG-INV's missions have evolved and escalated as a result of the terrorist attacks of September 11, 2001; the increasing sophistication of criminal enterprises; and new and developing statutory requirements. In the aftermath of September 11, DCIS's traditional areas of concentration (major procurement fraud with emphasis on defective and substandard products, cyber crimes, healthcare fraud, and public corruption) were expanded to include anti-terrorism operations and technology protection investigations (illegal transfer, theft, or diversion of DoD technologies and U.S. Munitions List items to proscribed nations and persons). DCIS participates with the Federal Bureau of Investigation (FBI) on Joint Terrorism Task Forces (JTTFs) at the FBI headquarters and at 45 locations across the U.S. DCIS is an integral participant in the Department of Justice's Technology Protection Enforcement Group (TPEG). The TPEG is comprised of several law enforcement and counterintelligence agencies and is designed to stem the illegal diversions of DoD technology, weapon systems, and equipment through an intensive criminal investigative effort and awareness training to include tailored briefings designed to encourage DoD and contractor employees to report to DoD law enforcement agencies crimes impacting DoD programs.

DCIS is the criminal investigative arm of the DoD OIG. DCIS protects America's warfighters by investigating terrorism, shielding our defense technology against those who seek to steal or use it against the United States or its allies; investigating companies that use substituted or substandard parts in weapons systems and equipment utilized by the military; investigating cyber crimes and computer intrusion; and investigating cases of fraud, bribery, and corruption, among other crimes. DCIS is a full participating member of the Department of Justice Asset Forfeiture Program and has contributed \$20,415,481 to the fund through forfeitures of cash and property as a result of DCIS' efforts on a variety of investigations.

DCIS special agents have full law enforcement authority, make arrests, carry concealed weapons, execute search warrants, serve subpoenas, and testify in legal proceedings.

ISO ensures that ethical violations, abuses of authority, or misuses of public office do not undermine the credibility of the national command structure. ISO was established in 1991 after Members of Congress expressed concern about the quality of senior officials' investigative work conducted by the Service IGs.

MRI conducts and oversees investigations of whistleblower reprisal under three Federal whistleblower protection statutes: 10 U.S.C. 1034 (military members); 10 U.S.C. 1587 (non-appropriated fund employees); and 10 U.S.C. 2409 (DoD contractor employees). The MRI conducts or oversees investigations of alleged violations of DoD Directive 6490.1, "Mental Health Evaluations of Members of the Armed Forces." The expansion of GWOT has increased the number of whistleblower reprisal complaints submitted by military members and Defense

contractor employees. Additionally, Congress recently broadened statutory protections for Defense contractor employees, which is anticipated to increase the number of reprisal complaints submitted to the DoD OIG. Military reprisal allegations comprise more than 80 percent of the MRI's workload.

CRI reviews and investigates whistleblower reprisal allegations submitted to the DoD hotline by DoD civilian appropriated fund employees. The CRI remains the sole centralized resource for investigating reprisals against DoD intelligence and counter-intelligence whistleblowers. As a leader in the whistleblower protection field, it has become the mentor to programs at the National Security Agency (NSA), Defense Intelligence Agency (DIA), National Geospatial-Intelligence Agency (NGA), National Reconnaissance Office (NRO), and within the service intelligence communities.

Policy and Oversight

Per Sections 4 and 8 of the Inspector General Act of 1978, as amended, the DoD OIG is to provide policy, guidance, and oversight to audit, inspections, evaluations, and investigative activities within the DoD and to provide analysis and comments on all proposed draft DoD policy issuances. The Office of the Deputy Inspector General for Policy and Oversight (ODIG-P&O) performs those functions. In addition, the ODIG-P&O provides technical support to DoD OIG organizations; provides the report follow-up function for the DoD OIG and Government Accountability Office (GAO); and evaluates DoD programs and functions. To support GWOT and Southwest Asia (SWA) efforts, the ODIG-P&O continue to evaluate both DoD's warfighting mission and its stabilization, security, transition, and reconstruction mission. The ODIG-P&O also continues to respond to congressional and management requests to review audits, inspections, evaluations, investigations, and inquiries conducted by the DoD or others in support of the DoD mission.

Intelligence

The Office of the Deputy Inspector General for Intelligence (ODIG-INTEL) audits, evaluates, and reviews the programs, policies, procedures, and functions of the DoD Intelligence Community, special access programs, the Defense nuclear program and operations, and other highly classified programs and functions within the DoD (hereafter referred to collectively as DoD intelligence (DIG-INTEL)). The DIG-INTEL is the primary advisor to the IG and through the IG to the SECDEF and other OSD leaders on intelligence audit and evaluation matters. The ODIG-INTEL audits, reviews, and evaluates topics determined by law, requests from the SECDEF and other DoD leadership, DoD hotline allegations, congressional requests, and internal analyses of risk in DoD intelligence programs. The ODIG-INTEL also works closely with other Federal agency and organization Inspectors General, such as the Central Intelligence Agency, Director of National Intelligence, and Department of Justice, coordinating and collaborating on projects to ensure proper operation, performance, and results for national intelligence activities.

The ODIG-INTEL personnel also assist the Office of the Director of National Intelligence Inspector General (ODNI-IG) to administer, coordinate, and oversee the functions of the

Intelligence Community Inspectors General (ICIG) Forum. The ICIG Forum promotes and improves information sharing among Inspectors General of the intelligence community. It also enables each IG to carry out the duties and responsibilities established under the Inspector General Act of 1978, as amended, to avoid duplication and to ensure effective coordination and cooperation. As the advisor to the DoD Inspector General, the ODIG-INTEL advocates developing and assessing metrics to measure the performance of the Intelligence Community's programs and operations in attaining the President's National Security Strategy and the SECDEF's pronouncements on improving intelligence. The ODIG-INTEL anticipates that the requirement for joint projects will increase, especially until the ODNI-IG is staffed to a sufficient level. Topics under deliberation for joint projects include procurement and contracting, counter-espionage information sharing, counterterrorism information sharing, security clearance reciprocity, open source intelligence, and other intelligence community issues that are critical to national security.

Special Plans and Operations

To more effectively support DoD, in April 2008, the DoD OIG established a new component, the Office for Special Plans and Operations (SPO). Its mission is to facilitate informed decision-making by senior leaders of the DoD, U.S. Congress, and other Government organizations by providing timely, high-value assessment reports on strategic challenges and issues, with a special emphasis on the GWOT and U.S. operations in SWA.

SPO was initially staffed with a core of 6 personnel from within the OIG and grew to 19 deployable military and civilian personnel within the first 6 months. SPO plans to double its staff in FY 2009 in order to reach its current ceiling of 35 personnel. Assessment teams are augmented by detailed personnel from within the DoD OIG and from other DoD and Federal agencies who have the specific knowledge, skills, and experience to evaluate the issue areas being addressed.

Office of the General Counsel

The Office of General Counsel reports to the Inspector General and is responsible for providing legal advice and counsel on all aspects of the missions of the Office of the Inspector General and its component organizations. The Acting Inspector General determined, shortly after assuming his position, that it was critical for the Office of General Counsel to be organizationally independent from the General Counsel of the Department of Defense. Acting upon the request of the Acting General Counsel, the Deputy Secretary of Defense, by a memorandum dated September 23, 2008, established "within the Office of the Inspector General of the Department of Defense an Office of the General Counsel, which is outside the DLSA [Defense Legal Services Agency], and not under the authority, direction and control of the General Counsel of the Department of Defense." This memorandum took the final steps necessary to clearly and firmly communicate the fact that the DoD OIG Office of General Counsel is an independent legal office fully responsible and accountable only to the DoD Inspector General.

VI. Budgetary and Financial Aspects

The DoD OIG remains focused on accomplishing its goals of improving the economy, efficiency, and effectiveness of Department of Defense personnel, programs, and operations, as well as eliminating and preventing fraud, waste, and abuse in the programs and operations of the Department. The DoD OIG maintains focus on the years ahead to ensure that those who are sent forward in locations around the world are trained and have the support that they need to provide proper oversight and to ensure good stewardship over all the DoD OIG has been entrusted, especially our troops and those that support them.

Because of the size and complexity of the DoD financial statements, the Department continues to face financial management challenges. These challenges make it difficult for the Department to provide reliable, timely, and useful financial and managerial data to support operating, budgeting, and policy decisions. Much has been done over the last few years to address these challenges, but the Department needs to continue to be vigilant in its efforts to provide accurate and usable financial information to its managers for decision making purposes.

The DoD OIG is working closely with the Department to address longstanding financial management challenges and supports the DoD goal of achieving a favorable audit opinion for the DoD agency-wide financial statements and the major DoD components. The Under Secretary of Defense (Comptroller)/Chief Financial Officer issued the DoD Financial Improvement and Audit Readiness Plan as part of an initiative to improve financial management within the Department. The DoD OIG supports the objective of the plan, which is to provide ongoing, cross-functional collaboration with DoD components to yield standardized accounting and financial management processes, business rules, and data that will provide a more effective environment to better support the warfighting mission. The DoD OIG also supports the Department's ongoing efforts to target achievable, incremental change and to initiate the adjustments necessary for continual, sustainable improvement in financial management.

Financial Condition

The DoD OIG annually assesses the most serious management and performance challenges faced by the DoD based on the findings and recommendations of audits, inspections, and investigations conducted during the year. The DoD OIG's Comptroller Office provides effective stewardship of resources, provides timely and accurate financial information, and ensures quality customer service.

The DoD OIG's annual appropriation for FY 2008 was \$240 million. The DoD OIG also received \$125,000 for the employee drug testing program, \$4.4 million for the GWOT, \$2 million for Research Development Testing and Evaluation (RDT&E), and \$1.45 million in reimbursable authority. The funding amount increased available funds by \$24.5 million from FY 2007 to FY 2008 in order to accomplish the DoD OIG goals of improving the economy, efficiency, and effectiveness of Department of Defense personnel, programs, and operations, as well as eliminating and preventing fraud, waste and abuse in the programs and operations of the Department. Funds will be used to increase audit staff, expand field offices, and provide for essential operational costs. The additional funding will allow the DoD OIG to establish offices in Germany and Hawaii and expand the Tampa, Florida field office. The DoD OIG returned

\$3.6 million for reprogramming to the Office of The Under Secretary of Defense (Comptroller) OUSD(C) as a result of internal reprogramming for the Foreign Currency Fluctuation account.

Limitations to the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the DoD OIG, as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The DoD OIG principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 United States Code 3515 (b) and in accordance with the DoD Financial Management Regulation, OMB Circular A-136, *Financial Reporting Requirements*, and U.S. Generally Accepted Accounting Principles (GAAP) for Federal entities. While the statements have been prepared from the books and records of the entity in accordance with GAAP for Federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication is the liabilities cannot be liquidated without legislation that provides resources to do so.

VII. Systems, Controls, and Legal Compliance

DoD OIG Systems

The DoD OIG depends on a variety of DoD systems to record, summarize, and report its financial information. Some of the systems include:

- Washington Allotment and Accounting System (WAAS)
- Defense Departmental Reporting System (DDRS)
- Headquarters Accounting and Reporting System (HQARS)
- CFO Loan and Reconciliation System (CLRS)

Currently, the DoD's systems are not in full compliance with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. In its effort to ensure the DoD-wide critical accounting, finance, and feeder systems comply with Federal financial management requirements, the DoD established the Senior Financial Management Oversight Council (SFMOC). This council oversees and provides guidance in the implementation of the Financial and Feeder Systems Compliance.

Due to the complexity and multiple systems currently used by DoD to process its financial transactions and prepare its financial statements, it will take time for its financial accounting systems to become fully compliant with applicable laws and regulations, including FFMIA.

Controls and Legal Compliance

The DoD OIG's transactions are executed in accordance with budgetary and financial standards and other requirements, consistent with the purpose authorized and are recorded in accordance with Federal Accounting Standards, Generally Accepted Accounting Principles (GAAP), and Statements of Federal Financial Accounting Standards (SFFAS). Assets are properly acquired and used, safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud. Performance measurement information is adequately supported.

The DoD OIG's senior management evaluated the system of internal accounting and administrative control, in effect during the fiscal year ending September 30, 2008, in accordance with the guidance in OMB Circular No. A-123 (Revised), *Management Accountability and Control*, dated August 5, 2005, as implemented by DoD Instruction 5010.40, *Managers' Internal Control Program Procedures*, dated January 4, 2006. The OMB guidelines were issued in consultation with the Comptroller General of the United States, as required by the Federal Managers' Financial Integrity Act of 1982. The DoD OIG's senior management also performed an evaluation of whether the system of internal accounting and administrative control for the DoD OIG is in compliance with standards prescribed by the Comptroller General.

The objectives of the system of internal accounting and administrative control of the DoD OIG are to provide reasonable assurance that:

- The obligations and costs comply with applicable laws;
- Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- Revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of reliable accounting, financial, and statistical reports and to maintain accountability over the assets.

The results indicate that the DoD OIG system of internal accounting and administrative control, in effect during the fiscal year ending September 30, 2008, provides reasonable assurance that management controls are in place, operating effectively, and being used.

VIII. Performance Goals and Objectives

Strategic Plan

The DoD OIG Strategic Plan supports the Department's mission (to include priorities identified by the SECDEF and the President's Management Agenda (PMA)). The DoD OIG mission is to promote integrity, accountability, and improvement of DoD personnel, programs, and operations to support the Department's mission, including winning the GWOT and other SECDEF top priorities, full and timely implementation of the PMA's primary goals and objectives, and addressing management challenges identified by the DoD OIG and the GAO's High-Risk Areas.

The DoD OIG Strategic Plan includes key objectives to provide independent, objective, and relevant information to the Department, Congress, other government agencies, and the public; promote ethics and integrity within the Department; prevent and detect fraud, waste, and abuse;

achieve the PMA initiatives; ensure accountability for mission accomplishment and strategic human capital management and merit system principles; and improve the planning and use of DoD OIG resources to ensure relevant and timely information to senior-level decision makers on critical issues.

In order to monitor performance against the plan, the DoD OIG complies with the Government Performance and Results Act of 1993, as amended, and tracks goal attainment to measure progress and results to ensure a return on investment of taxpayer dollars. One of the key methods of monitoring performance is through the DoD OIG quarterly performance report that assesses each functional component in the following six categories: 1) timeliness of projects; 2) coverage of key areas (such as DoD transformation priorities, IG identified management and performance challenges, and the PMA); 3) return on investment; 4) external engagement; 5) budget; and 6) personnel. In addition to the DoD OIG quarterly performance report, each component maintains its own system of monitoring performance.

Strategic Goals

The DoD OIG has identified three strategic goals and key objectives corresponding to those goals which are pertinent to the implementation of its Strategic Plan.

GOAL 1: Improve the economy, efficiency, and effectiveness of Department of Defense personnel, programs and operations.

Objectives:

- Provide independent and objective audits, evaluations, and investigations of DoD programs and operations and fully inform the Secretary of Defense and the Congress about potential problems and deficiencies.
- Identify and execute projects focused on improving efficiency and effectiveness in key strategic areas as identified by the Inspector General.
- Recommend solutions to resolve identified risks and weaknesses.
- Provide independent and objective information products to the Department, Congress, other Government agencies, and the public.

GOAL 2: Eliminate fraud, waste, and abuse in the programs and operations of the Department.

Objectives:

- Improve the ability of the Department to accomplish its mission by detecting and preventing fraud, waste, and abuse.
- Promote accountability, ethics and integrity within the Department.
- Provide independent and objective information products to the Department, Congress, other Government agencies, and the public.
- Promote public confidence in the DoD leadership and programs.

GOAL 3: Ensure the efficiency and effectiveness of DoD OIG work products, processes, and operations.

Objectives:

- Establish short- and long-term priorities for the DoD OIG.
- Support the President's Management Agenda.
- Ensure accountability for mission accomplishment.
- Ensure accountability for strategic human capital management and merit system principles.
- Improve the planning and use of DoD OIG resources to ensure that relevant and timely information is provided to senior-level decision makers on critical issues.
- Ensure that DoD OIG performance measures focus on outcomes and impacts.
- Improve component unique operations.
- Capitalize on opportunities to integrate efforts of DoD OIG components.
- Optimize jointness/coordination with other oversight agencies (leverage resources).
- Ensure DoD OIG personnel receive the training and education needed to develop their full potential.

IX. Results

Audit

In FY 2008, the ODIG-AUD produced 137 reports that claimed potential monetary benefits totaling \$1.439 billion. During FY 2008, ODIG-AUD also achieved \$1.036 billion in monetary benefits from reports issued in earlier years. The funds were put to better use because of actions completed on audit recommendations. Since FY 2006, there has been an average return on investment of \$11.9 million in monetary benefits achieved per DoD OIG auditor each year. The ODIG-AUD goal is for 95 percent of completed audits to provide at least one of the following five benefits: 1) improvement of business operations; 2) compliance with statutes or regulations; 3) improvement of national security; 4) identification of potential monetary benefits; and 5) improvement of the effectiveness of the safety of service members.

The additional funding received by the DoD OIG in FY 2008 allowed the ODIG-AUD to fill 27 new positions to increase oversight of high risk areas and to focus on contracting, logistics, weapons acquisition, health care, maintenance, and SWA audit operations.

In FY 2008, ODIG-AUD had over 350 auditors supporting over 85 GWOT-related oversight efforts, including 25 issued GWOT reports covering areas related to acquisition and contracting, funds management, readiness, logistics, equipping the warfighter, and management of contractor common access cards; ODIG-AUD also completed a comprehensive plan for a series of audits of Defense contracts, subcontracts, and task and delivery orders for the logistical support of coalition forces in Iraq and Afghanistan as required by Section 842 of the National Defense Authorization Act for Fiscal Year 2008; established a field office in Korea to focus on the major restructuring of the current force structure; and formed an expeditionary audit division, complemented by U.S. based audit teams, in order to address corruption, fraud, waste, and abuse

in SWA; combat illegal and improper expenditures; and improve accountability of DoD resources that support operations in SWA.

Priority demands on audit resources include:

- The Chief Financial Officer's Act of 1990, as amended by the Federal Financial Management Act of 1994;
- The Intelligence Authorization Act for FY 2002, which requires the DoD OIG to audit the form and content of the financial statements of the National Security Agency, National Geospatial-Intelligence Agency, and Defense Intelligence Agency;
- The need to expand the DoD OIG presence in SWA and increase coverage of GWOT-related contracting, programs, and operations;
- Reports required or requested by Congress and senior DoD officials or resulting from hotline allegations;
- Reports focused on improving contract surveillance, funds management, and other accountability issues;
- Reports on improving weapons acquisition and general contract management with emphasis on identifying potential procurement fraud; and
- Efforts to improve DoD processes which, while beneficial, do not result in reports that can be reflected in the DoD OIG productivity statistics.

During FY 2008, the auditors issued the following: a) disclaimers of opinion on the DoD Agency-wide FY 2007 financial statements and eight of the components' statements that support the Agency-wide statements; b) a qualified opinion on the U.S. Army Corps of Engineers FY 2007 and FY 2006 financial statements, c) an endorsement of an unqualified opinion on the Military Retirement Fund FY 2007 financial statements; and d) an endorsement of a qualified opinion on the Medicare Eligible Retiree Health Care Fund FY 2007 financial statement. In addition, the auditors performed audits or provided contractor oversight on four financial systems audits and performed approximately 80 other audits on internal controls, compliance with laws and regulations, and other financial-related issues. As OSD and components have identified segments of financial statements that are ready for review, ODIG-AUD has announced audits or attestation engagements, as appropriate. Specifically, the DoD OIG is auditing or overseeing financial audits or examinations for the Defense Information Systems Agency (DISA) FY 2007 and FY 2008 balance sheets, the Defense Threat Reduction Agency FY 2008 financial statements, and TRICARE Management Activity's Contract Resource Management Balance Sheet. The ODIG-AUD also continues to perform internal control and compliance reviews over systems and property and attestation reviews of the DoD Counterdrug program, which is an annual requirement from the Office of National Drug Control Policy Re-authorization Act of 2006. In FY 2008, the DoD OIG again limited its financial statement audit work and redirected the Defense Financial Auditing Service staff to work on audits related to the Government Purchase Card Program and internal control and compliance reviews over systems and property. The DoD submitted the latest version of the Financial Improvement and Audit Readiness (FIAR) Plan to congressional defense committees in March 2008, in accordance with the National Defense Authorization Act for Fiscal Year 2006.

Investigations

DCIS conducts investigations into the illegal diversion, theft, or movement of strategic technologies and U.S. Munitions List items to proscribed nations, terrorist organizations and other criminal organizations that pose a threat to national security. Technology protection-related investigations have grown to encompass approximately 14 percent of DCIS' active caseload. DCIS is currently recognized by the Department of Homeland Security, FBI, and various members of the Intelligence Community as the primary DoD criminal investigative element supporting the on-going battle against counter-proliferation and illicit technology transfer.

DCIS investigations have resulted in 158 criminal indictments, 257 convictions, and over \$443.5 million in criminal, civil, and administrative recoveries (excluding headquarters and field managers, an average of \$1.6 million per agent, per year). Since its inception, DCIS has participated in cases that have resulted in \$13.6 billion in criminal, civil, and administrative recoveries. Further, DCIS supports crucial national defense priorities by effectively and efficiently using limited investigative resources and primarily emphasizing investigations of terrorism, product substitution/defective parts, illegal technology transfer, and public corruption.

MRI has the statutorily mandated mission of whistleblower protection for Military Service members, DoD non-appropriated fund employees, and DoD contractor employees. The basic criteria for evaluating MRI is the number of reprisal complaints closed, both those investigated in-house and those conducted by Military Department IGs and submitted to MRI for oversight review. MRI received 624 reprisal complaints, of which 372 were examined by Military Department IGs under MRI oversight. Of the 624 complaints, 540 cases were closed after preliminary inquiries. Faced with a continuing increase in whistleblower reprisal allegations received by both the DoD OIG and the Military Department IGs (from 320 complaints received in FY 1997 to 624 complaints received in FY 2008), MRI strives to implement policies and procedures that will improve the timeliness in processing and resolving such allegations. The Directorate conducts training workshops on military whistleblower reprisal investigations for representatives of the Military Services, the Joint Chiefs of Staff, and other Defense agencies.

CRI has the primary mission of whistleblower protection for civilian appropriated fund personnel and carries out this mission by reviewing and investigating whistleblower reprisal allegations submitted to the DoD Hotline. The basic criteria for evaluating CRI operations is the number of investigations conducted or overseen. Oversight cases are those in which a DoD component investigated and CRI reviews the final product for sufficiency. CRI closed five cases and opened six. CRI currently has 12 open matters. CRI expects to increase its case closure rate in the future, giving highest priority to contractor fraud and abuse within the Defense Intelligence and counter-intelligence communities. In FY 2009, CRI will apply additional resources to the stand-up of a Procurement Fraud Reprisal Team with the same capacity as its existing National Security Reprisal Team.

Investigations of Senior Officials (ISO) Directorate completed 39 inquiries or investigations. ISO also oversaw 190 investigations by DoD components and evaluated the impact of those investigations on public confidence in DoD leaders and ultimately on national security.

Investigative impact may be evaluated by the overall number of investigations ISO conducted or provided oversight, the percentage of investigations that were of significance to DoD or congressional leaders, and the percentage of investigations that substantiated alleged misconduct. Twenty-eight percent of investigations conducted by ISO had significant media, SECDEF, or congressional interest, with results provided directly to the SECDEF or Members of Congress. These investigations involved complicated issues of public interest and were manpower intensive because of the extensive fieldwork required. Examples of ISO work products include investigations into alleged conflicts of interest on the part of senior DoD officials, the alleged mismanagement of an aircraft procurement program, and the alleged failure to use intelligence data obtained by the Able Danger anti-terrorist program.

Thirty percent of the investigations substantiated allegations against senior officials and resulted in immediate removal from command, reprimands, reductions in rank, and reimbursement to the Government, thereby demonstrating that the Department holds senior leaders accountable for misconduct. Statistics indicate the increasing complexity of allegations involving senior officials and associated requirement for comprehensive, manpower intensive investigative work. Recent examples in the area of senior official inquiries include substantiated allegations of using Government property for unauthorized purposes, taking official action for private gain, conducting official travel for personal benefit, accepting of gifts from prohibited sources, improperly supporting a non-Federal entity, and taking unauthorized personnel actions. As part of its responsibility to fully inform the President and Senate of adverse information concerning senior officials being nominated for promotion, reassignment, or other action, ISO conducted over 9,300 name checks on DoD senior officials in the past year. The Senate Armed Services Committee relies exclusively on checks completed by ISO before confirming military officer promotions. In FY 2009 to FY 2011, ISO will continue to address allegations of senior official misconduct that demoralize warfighters and undermine public confidence in DoD leadership. A primary objective is to reduce investigative cycle time on senior official investigations so that results are provided to top DoD officials and members of Congress more quickly.

Policy and Oversight

Policy and Oversight operations are evaluated on the reviews conducted, as measured by the significance and quality of audit, inspection, evaluation, and investigative policies provided; oversight and evaluation reports issued; voluntary disclosures processed; subpoenas processed; timeliness and quality of technical support provided; positive impact on draft DoD policy issuances; follow-up actions taken relative to DoD report recommendations; and outcomes from evaluations of significant DoD programs and operations. In FY 2008, Policy and Oversight issued 33 reports, commented and coordinated on 316 draft DoD policies for the IG, provided technical support to approximately 250 audit and investigative projects, and documented the implementation of corrective actions on over 200 DoD OIG and GAO reports and over 1,100 recommendations to improve DoD operations.

In FY 2008, the Assistant Inspector General for Audit Policy and Oversight (APO) issued 13 oversight reports including five reports concerning DoD hotline allegations, one best practices report on audit and financial advisory committees in DoD, a review of actions on incurred cost audits by the supervisor of shipbuilding, and six quality control reviews of Single Audits of

nonprofit organizations and DoD/Military Audit Organizations. In addition, APO reviewed and commented on 201 Single Audit reports. The APO staff also participated on various DoD and Government-wide working groups that address significant issues impacting audit and accountability professionals within DoD; Federal, state, and local government; and the private sector. The APO provided comments on the draft President's Council on Integrity and Efficiency/Executive Council on Integrity and Efficiency External Peer Review Guide. The APO also coordinated on 48 revisions to procurement regulations, commenting on seven to ensure the revisions did not adversely impact the DoD. Also, APO provided training on government auditing standards, external peer reviews, audit committees, and Single Audit at various conferences, including conferences sponsored by the Association of Government Accountants (AGA) and the American Institute of Certified Public Accountants (AICPA). Finally, the APO provided oversight of 1,717 open contract audit reports with over \$5.3 billion in potential savings.

The Assistant Inspector General for Investigative Policy and Oversight (IPO) helped recover \$425 thousand dollars during FY 2008 through voluntary disclosures of fraud against DoD. The office issued 354 subpoenas for DoD investigations of fraud and other select criminal offenses, a 18 percent increase over last year while maintaining cycle time below the office's 15-day metric. In its oversight work, the IPO has completed reviews of cases attracting international notoriety, including the fratricide of a former professional football player and the jailing of an Army Muslim chaplain from Guantanamo Bay. During FY 2008, IPO's work has included the effectiveness and thoroughness of death investigations of service members and non-combatants in Iraq. The work focused on specific events such as the killing of a shepherd in Afghanistan and a news cameraman in Iraq. In addition, IPO is reviewing the electrocution deaths of military members and contractors in Iraq due to faulty electrical wiring and equipment. This high level project involved performing hundreds of interviews and the analysis of thousands of pages of previous investigative work. The IPO's work products captured strong interest in Congress and the media and withstood detailed, aggressive oversight by external sources. The office's reputation as an honest broker of information resulted in the referral of a sensitive complaint about the shooting death and injury of international news service employees in Baghdad by U.S. forces, allowing DoD to solve DoD problems, which serves as the oversight measure of effectiveness.

In FY 2008, the Assistant Inspector General for Inspections and Evaluations (I&E) issued 14 reports: two interagency reports—DoD/DVA evaluation of the medical care transition program for wounded warriors and a DoD/Department of Education assessment of contracting program for Military dining facilities; four safety survey reports; an interim report on the global train and equip programs for partner nations; an assessment of the Iraqi Security Forces IG System; and an evaluation of the Federal voting assistance program. Other completed reports reviewed training issues in Iraq, DoD mental health programs, accident reporting processes, and contract management. In FY 2008, I&E staff members deployed to Iraq, Afghanistan, and Pakistan and completed field work for projects involving munitions accountability, logistics, training and equipping foreign military forces, counter-terrorism, counter-narcotics, capacity building, and bilateral planning. The Directorate is completing several major projects that will bridge into FY 2009. These projects include the following: 1) a review of electrocution accidents in Iraq; 2) an examination of DoD public affairs outreach program for the GWOT; 3) an evaluation of the DoD

safety program; 4) an assessment of the medical records management process; (5) the 2008 DoD voting assistance program; and 5) the inspection of the Armed Forces Retirement Home. These ongoing projects will compete for resources as other projects are added to the Directorate's portfolio.

Intelligence

The ODIG-INTEL focuses on assessing the efficient, effective, and appropriate use of intelligence personnel and resources with emphasis on support to the warfighter and national command authority. In FY 2008, the ODIG-INTEL provided DoD leadership and Congress with 15 intelligence evaluation and audit reports on topics, such as Threat Assessment Guidance Regarding Nuclear Weapons Located outside the Continental United States, NSA programs and initiatives, and Special Access Programs. A specific high-interest issue in FY 2008 was a detailed review of United States Government's relationship with the Iraqi National Congress, especially the relationship with DoD. Congressionally directed actions or requests, management requests, or DoD hotline complaints initiate 64 percent of ongoing projects. The other 36 percent comes from a proactive process of identifying projects to promote effective operations and ensure efficient use of resources in vital intelligence and related mission areas in support of the Department's goals and the DoD OIG's Strategic Plan.

In FY 2008, the ODIG-INTEL continued to follow a rigid performance measure in the Strategic Plan to plan, staff, and manage projects in order to complete them within an average of 300 days. In FY 2009, the ODIG-INTEL will continue to define project scope and objectives to improve cycle time. The ODIG-INTEL will continue to participate in quarterly meetings of the Intelligence Community Inspectors General (ICIG) Forum and chair the Joint Intelligence Oversight Coordination Group (JIOCG) to prevent duplication and overlap between the DoD OIG, service audit agencies, Military IGs, and other Intelligence agencies components, or jointly with DoD Intelligence agency IGs and Intelligence Community IG Forum members.

Special Plans and Operations

To provide "proof of concept," the DoD Inspector General organized and led a Special Plans and Operations (SPO) assessment team to Iraq, Kuwait, and Afghanistan in September 2007. The mission's objective, specifically requested by the Secretary of Defense, was to establish the effectiveness of accountability and control over arms and ammunitions that the U.S. had been providing the Iraqi Security Forces and to recommend immediate implementation of actions to address any issues identified. Additional focus areas were added during the trip to include the Foreign Military Sales program and logistics sustainability. The related classified IG Report No. SPO-2208-001, *Assessment of the Accountability of Arms and Ammunition*, provided to the Security Forces of Iraq was published on July 3, 2008.

A follow-up trip was led by the Principal Deputy Inspector General in April 2008 to appraise the actions taken since the first assessment visit to Iraq and also included a trip to Afghanistan to initiate a review of the same issue areas. *Assessment of Arms, Ammunition, and Explosives Accountability and Control; Security Assistance; and Sustainment for the Afghan National Security Forces*, the first of two draft reports, was released for management comments on August

11, 2008, and is currently being finalized. *Assessment of Arms, Ammunition, and Explosives Accountability and Control; Security Assistance; and Sustainment for the Iraqi Security Forces*, the second draft report resulting from that trip, was released for management comments on September 26, 2008.

In April 2008, another SPO team, led by the DoD Inspector General and requested by the Secretary of Defense, conducted a mission to Pakistan in order to review U.S. security assistance programs in that country. *Assessment of DoD-Managed Programs in Support of the Government of Pakistan*, a classified discussion draft, was released for management comments on September 8, 2008, which contained the preliminary results of that assessment.

SPO is preparing an assessment for the Joint Chiefs of Staff on the effectiveness of the Section 1206, global “train and equip” mission in support of the GWOT. It is also organizing a deployment to Iraq in late October 2008 to assess DoD oversight of night vision devices provided to the Iraqi Security Forces. In addition, SPO has announced a new assessment initiative to address to the DoD “Wounded Warrior” program.

X. Events, Trends, and Risks

Global War on Terror

The DoD OIG is committed to supporting the GWOT and the needs of the men and women fighting this war. Overall, the DoD OIG is responsible for providing oversight to more than \$655 billion in funds dedicated for the GWOT. The responsibility of the DoD OIG is to identify and help fix critical mission support problems that impact Operations Enduring Freedom and Iraqi Freedom.

The DoD OIG has established the following GWOT-related goals:

Goal 1: Increase the DoD OIG presence in SWA to work on priority issues directly supporting efforts for Operation Enduring Freedom and Operation Iraqi Freedom.

Goal 2: Continue in-depth coverage of DoD GWOT related programs and operations by providing oversight in fundamental areas, contract surveillance, financial management, accountability of resources, as well as training and equipping of personnel and developing a logistics sustainment base.

Goal 3: Continue to actively support Joint Terrorism Task Forces and increase efforts to prevent the illegal transfer of strategic technologies and U.S. Munitions List items to proscribed nations, terrorist organizations, and other criminal enterprises.

To accomplish its oversight mission, the DoD OIG has adopted a strategy that is based on maintaining the ideal presence in theater while simultaneously recognizing that much of our work can be done away from the war zones, ensuring safety of personnel and saving the unnecessary monetary funds it would cost to send our people there. An important part of our oversight effort is to improve inter-service and interagency coordination and collaboration to

minimize duplication of effort and ensure that we have only the staff needed in theater to accomplish the mission.

To provide a more effective and efficient oversight role, the DoD OIG has established field offices in strategic SWA locations and continues key placement of DoD OIG personnel in SWA. This strategy facilitates timely reviews and reporting of results in theater and minimizes disruption to the warfighter. The DoD OIG has adopted an expeditionary workforce model to support efforts throughout all of SWA. The DoD OIG has core staff forward deployed at all times. The core contingent is composed of individuals serving between six and twelve-month deployments. Expeditionary team members deploy for as long as needed to complete the review. The actual number of auditors, investigators, and inspectors in SWA fluctuates on a daily basis depending on the requirements. For FY 2008, the DoD OIG has deployed over 100 personnel into theater.

Iraq Field Offices

In coordination with the Commanding General, Multi-National Force-Iraq (MNF-I) and the U.S. Central Command, the DoD OIG established field offices in Iraq at Camp Victory and the International Zone. The Iraq offices are staffed with up to five auditors at a time. Recently, auditors from the Iraq offices supported DoD OIG staff who were temporarily in Iraq to perform a joint follow-up review with the MNF-I Inspector General's Office on the equipment status of forces in Iraq. In addition, the DoD OIG has assigned auditors in Iraq to provide the Defense Criminal Investigative Service support for ongoing criminal investigations pertaining to contract fraud. The auditors in Iraq also provide support to DoD OIG teams based in the continental United States performing oversight related to Iraq such as the management of contractor issues within SWA and the Army Reset program.

DCIS has established a permanent presence in Iraq. Five special agents are currently deployed to Iraq, which includes two special agents assigned to Iraq. An additional special agent has been temporarily deployed to support a special cell investigating issues relating to weapons accountability. These in-theater agents are the forward-deployed elements of the approximately 93 DCIS special agents participating in SWA investigations.

Afghanistan Field Office

In coordination with the Commander, Combined Joint Task Force-82 and the U.S. Central Command, the DoD OIG established a field office in Afghanistan at Bagram Air Base. Three full time auditors and a six-member expeditionary team staff the Afghanistan Field Office. The auditors are conducting several projects, including audits on "The Procurement and Use of Non-tactical Vehicles at Bagram Air Field, Afghanistan" and "Management and Accountability of Property Purchased at Regional Contracting Centers in Afghanistan." In addition, the auditors in Afghanistan issued a report regarding contingency construction contracting procedures implemented by the Joint Contracting Command-Iraq/Afghanistan. Our auditors in Afghanistan are providing support to DoD OIG teams based in the continental United States looking at contractor issues within SWA.

Additionally, DCIS is developing a full-time presence in Afghanistan. Two special agents have been deployed to Afghanistan. These agents will work alongside partner agencies, such as the U.S. Army Criminal Investigation Command, to investigate fraud, waste, theft, corruption, abuse, and other crimes impacting theater operations.

Qatar Field Office

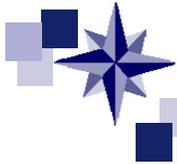
The DoD OIG established a field office in Qatar collocated with U.S. Central Command Air Forces on Al Udeid Air Base, Qatar. The Qatar office is our logistical support hub to facilitate our oversight staff deploying into and redeploying from theater to conduct oversight efforts. The Qatar office staff facilitates and may augment other teams that require temporary travel in theater to conduct specific reviews. In addition, the personnel in Qatar are providing support to DoD OIG teams based in the continental United States looking at the management of contractor issues within SWA. The Qatar office also provides administrative operations support to the DoD OIG SWA field offices.

Kuwait Field Office

The DoD OIG field office in Kuwait is staffed by two DCIS special agents who are focused on contract fraud and other potential criminal activities in Kuwait that impact SWA efforts.

GWOT, especially operations in SWA, continues to be a top priority of the DoD OIG and its five operational components by providing oversight of various functions and activities, such as contracts and contract fraud, readiness, logistics, funds management, accountability, theft, corruption, and intelligence efforts. The DoD OIG has either completed or is in the process of conducting oversight efforts that cover approximately \$133 billion related to DoD GWOT efforts.

The DoD OIG developed a comprehensive plan for a series of audits of Department of Defense contracts, subcontracts, and task and delivery orders for the logistical support of coalition forces in Iraq and Afghanistan in support of the National Defense Authorization Act for Fiscal Year 2008, Section 842, *Investigation of Waste, Fraud, and Abuse in Wartime Contracts and Contracting Processes in Iraq and Afghanistan*, January 28, 2008. An update to the comprehensive audit plan is being developed, which will present an increase in SWA-related oversight by the DoD OIG, other DoD oversight components, and Federal Inspectors General.



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Independent Auditors' Report

Introduction

We have audited the balance sheets of the Department of Defense Office of the Inspector General (DoD OIG) as of September 30, 2008 and 2007, as well as the related statements of net cost, changes in net position, and budgetary resources (the financial statements) for the years then ended. The objective of our audit was to express an opinion on the fair presentation of those financial statements. In connection with our audits, we also considered the DoD OIG's internal controls over financial reporting and tested the DoD OIG's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

As stated in our opinion of the financial statements, we found that the DoD OIG's financial statements as of and for the years ended September 30, 2008 and 2007, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal controls would not necessarily disclose all significant deficiencies in the internal controls over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants (AICPA). Our testing of internal controls identified a significant deficiency in financial reporting. Additionally, we identified significant deficiencies with a service provider concerning financial management systems and processes that we consider to be a material weakness in relation to the DoD OIG's financial statements. The financial systems used by the DoD OIG are not in compliance with the requirements of the Federal Financial Management Improvement Act (FFMIA).

The results of our tests of compliance with certain provisions of laws and regulations disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

The following sections discuss in more detail our report of the DoD OIG's financial statements, our consideration of the DoD OIG's internal control over financial reporting, and our tests of the DoD OIG's compliance with certain provisions of applicable laws and regulations.

Independent Auditors' Report

We have audited the accompanying balance sheets of the DoD OIG as of September 30, 2008 and 2007, and the related statements of net cost, changes in net position, and budgetary resources for the years then ended. These financial statements are the responsibility of the DoD OIG management. Our responsibility is to express an opinion of these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in the Government Auditing Standards, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatement. Our audits included consideration of internal controls over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the DoD OIG's internal controls over financial reporting. Accordingly, we do not express such an opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

As provided in OMB Circular No. A-136, *Financial Reporting Requirements*, effective for fiscal year 2007, the Statement of Financing was presented as a note per OMB's authority under SFFAS No. 7, *Accounting for Revenue and Other Financing Sources And Concepts for Reconciling Budgetary and Financial Accounting*, and is no longer considered a basic statement. The Statement of Financing is displayed in Note 14, Reconciliation of the Net Cost of Operations to Budget. The information is presented on a comparative basis for the years ended September 30, 2008 and 2007.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the DoD OIG as of September 30, 2008 and 2007, and its net cost of operations, changes in net position, and budgetary resources, for the years ended September 30, 2008 and 2007, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have issued our report dated November 6, 2008, on our consideration of the DoD OIG's internal controls over financial reporting and on our tests of compliance with certain provisions of laws, regulations, contracts, agreements and other matters. The purpose of that report is to describe the scope of our testing of internal controls over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal controls over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying required supplementary information, referred to as the Management Discussion and Analysis, is not a required part of the basic financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America, OMB Circular No. A-136. The supplementary information is the responsibility of the DoD OIG management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

Independent Auditors' Report on Internal Controls Over Financial Reporting and on Compliance and Other Matters Based on Audits Performed in Accordance with Government Auditing Standards

Our responsibility is to express an opinion on the financial statements as of and for the years ended September 30, 2008 and 2007, based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit, we considered the DoD OIG's internal controls over financial reporting by obtaining an understanding of the agency's internal controls, determining whether internal controls had been placed in operation, assessing control risks, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion of the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by Federal Managers Financial Integrity Act. Our procedures were not designed to provide assurance on internal controls over financial reporting. Consequently, we do not express an opinion thereon.

Our consideration of internal controls would not necessarily disclose all matters in internal controls that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. Under standards issued by the AICPA, a significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affect the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity financial statements that is more than inconsequential will not be prevented or detected. A material weakness, as defined by the AICPA and OMB Bulletin 07-04, is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. We believe that the following significant deficiencies are material weaknesses in financial reporting

under the direct control of the DoD OIG. Additionally, we identified matters, related to Defense Finance and Accounting Service's (DFAS) financial management systems, used to record, process, summarize and report the DoD OIG activities and results that we consider to be material weaknesses in relation to the DoD OIG's financial statements.

Financial Reporting

In the prior year, we reported that the DoD OIG management relies on the processes that have been designed within the DoD to process, record and report on financial transactions. The services for those processes are acquired from the DFAS and discussed in a Service Level Agreement. We reported that the fiduciary stewardship and responsibility over financial reporting that is inherent to management remains with the DoD OIG. We further reported that the DoD OIG does not 1) perform adequate managerial review of the information processed by DFAS, 2) have a process in place to ensure the completeness of the quarterly or year-end financial statements, and 3) have fundamental processes in place to ensure that transactions initiated are appropriately reviewed and approved. In the current year, we observed that the DoD OIG made substantial progress toward improving their financial reporting processes. We believe additional effort will be necessary to fully remediate the conditions.

- In the prior year, we observed that the DoD OIG performed many activities that replicate the actions taken by their service provider. In some cases the activities are more akin to converting data from one format to another (i.e. PDF to Excel). In the current year, business processes are in place to independently validate the information being processed by the service provider. These processes need to continue, in order to assure that data analysis of the financial reporting level is performed.
- In prior years we reported, and the condition continues in need of remediation, that the DoD OIG in conjunction with their service provider has not fully documented the crosswalks used to develop the DD 1176 from the WAAS general ledger. The DD 1176 serves as an integral piece of the audit trail from the general ledger to the Statement of Budgetary Resources. The DoD OIG did, however, adopt an interim process using alternative procedures by which we were able to validate the DD 1176 and the statement of budgetary resources. Additional actions are necessary to fully remediate this condition.
- We continued to observe that the DoD OIG does not have fully implemented business practices to perform adequate management review of transactions recorded to their books. In prior years, we observed newly implemented business processes to review the validity of lease or facilities costs recorded; however, in the current year there was limited progress on the development of policy and the refinement of processes to validate the amounts recorded for logistical support costs. The DoD OIG needs to identify, develop and implement management review and validation techniques to enable them to fulfill their management stewardship responsibilities.

These conditions create a vulnerability for material misstatement, lack of reliability and completeness of the DoD OIG's financial statements; thus we classified this condition as a significant weakness in financial reporting.

DoD Systems

As reported in prior years, the DoD OIG's service providers do not have systems that retain transaction level detail data necessary to support the DoD OIG's financial statement amounts. The basic accounting system captures data using object classes, not general ledger accounts. The object classes are translated into the DoD general ledger account totals using an automated program. As a result of the translation, the service provider must post numerous, often material adjustments to re-create beginning balances in net position accounts, reconcile proprietary accounts to budgetary accounts, and create a trial balance in U.S. Standard General Ledger (USSGL) format.

This issue is a part of long-standing, well-documented financial management systems weaknesses that have been reported by the DoD OIG Defense Financial Auditing Service and the Government Accountability Office in previous years' reports on the DoD financial statements and the government-wide financial statements, respectively. The DoD does not maintain systems that comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the USSGL at the transaction level.

The results of our tests of compliance with certain provisions of laws and regulations disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04.

As noted above, the DoD financial management systems did not substantially comply with Federal financial management system requirements, applicable Federal accounting standards, or the USSGL at the transaction level.

We noted certain matters that we reported to the DoD OIG management in a separate letter dated November 6, 2008.

Agency Comments

The DoD OIG provided comments to the Auditors' Report where they, generally concurred with each observation made related in our report. The DoD OIG comments and their planned corrective actions are included in Appendix A to this report.

This report is intended solely for the information and use of the management of the DoD OIG, DoD, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

November 6, 2008

Financial Statements

Department of Defense

Other Defense Organizations General Funds - Inspector General, Department of Defense

CONSOLIDATED BALANCE SHEET

As of September 30

(Amounts in thousands)

		2008		2007
ASSETS (Note 2)				
Intragovernmental:				
Fund Balance with Treasury (Note 3)	\$	41,319	\$	36,461
Accounts Receivable (Note 4)		1,096		
Total Intragovernmental Assets	\$	42,415	\$	36,461
Accounts Receivable, Net (Note 4)		108		62
Cash and Other Monetary Assets (Note 5)		85		0
Other Assets (Note 6)		253		253
TOTAL ASSETS	\$	<u>42,861</u>	\$	<u>36,776</u>
LIABILITIES (Note 7)				
Intragovernmental:				
Accounts Payable (Note 8)	\$	1,601	\$	3,303
Other Liabilities (Note 10)		3,178		2,584
Total Intragovernmental Liabilities	\$	<u>4,779</u>	\$	<u>5,887</u>
Accounts Payable (Note 8)	\$	1,780	\$	1,303
Military Retirement and Other Federal Employment Benefits (Note 9)		7,463		6,678
Other Liabilities (Note 10)		21,624		17,757
TOTAL LIABILITIES	\$	<u>35,646</u>	\$	<u>31,625</u>
NET POSITION				
Unexpended Appropriations - Other Funds		16,350		11,383
Cumulative Results of Operations - Other Funds		(9,135)		(6,232)
TOTAL NET POSITION	\$	<u>7,215</u>	\$	<u>5,151</u>
TOTAL LIABILITIES AND NET POSITION	\$	<u>42,861</u>	\$	<u>36,776</u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
CONSOLIDATED STATEMENT OF NET COST
For the Years Ended September 30
 (Amounts in thousands)

	2008	2007
1. Program Costs		
A. Gross Costs	\$ 249,789	\$ 229,974
B. (Less: Earned Revenue)	<u>1,128</u>	<u>(65)</u>
C. Net Program Costs	\$ 248,661	\$ 230,039
2. Cost Not Assigned to Programs	0	0
3. (Less: Earned Revenue Not Attributable to Programs)	<u>0</u>	<u>0</u>
4. Net Cost of Operations	<u>\$ 248,661</u>	<u>\$ 230,039</u>

Department of Defense

Other Defense Organizations General Funds - Inspector General, Department of Defense

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

For the Years Ended September 30

(Amounts in thousands)

	2008	2007
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (6,232)	\$ (4,402)
Prior Period Adjustments:		
Changes in accounting principles (+/-)	0	0
Corrections of errors (+/-)	0	0
Beginning balances, as adjusted	(6,232)	(4,402)
Budgetary Financing Sources:		
Appropriations used	236,274	217,420
Other budgetary financing sources	0	0
Other Financing Sources:		
Imputed financing from costs absorbed by others	9,437	10,776
Other (+/-)	46	13
Total Financing Sources	<u>245,757</u>	<u>228,209</u>
Net Cost of Operations (+/-)	248,661	230,039
Net Change	<u>(2,904)</u>	<u>(1,830)</u>
Cumulative Results of Operations	<u><u>(9,135)</u></u>	<u><u>(6,232)</u></u>
UNEXPENDED APPROPRIATIONS		
Beginning Balances	\$ 11,382	\$ 19,001
Prior Period Adjustments:		
Changes in accounting principles	0	0
Corrections of errors	0	0
Beginning balances, as adjusted	11,382	19,001
Budgetary Financing Sources:		
Appropriations received	246,389	216,297
Appropriations transferred-in/out	(3,752)	(4,178)
Other adjustments (rescissions, etc)	(1,395)	(2,317)
Appropriations used	<u>(236,274)</u>	<u>(217,420)</u>
Total Budgetary Financing Sources	4,968	(7,618)
Unexpended Appropriations	<u>16,350</u>	<u>11,383</u>
Net Position	<u><u>7,215</u></u>	<u><u>5,151</u></u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
COMBINED STATEMENT OF BUDGETARY RESOURCES
For the Years Ended September 30
 (Amounts in thousands)

	2008	2007
BUDGETARY FINANCING ACCOUNTS		
BUDGETARY RESOURCES:		
Unobligated balance, brought forward, October 1	\$ 11,452	\$ 15,584
Recoveries of prior year unpaid obligations	3,964	10,626
Budget authority		
Appropriation	246,389	216,297
Spending authority from offsetting collections		
Earned		
Collected	32	(65)
Change in receivables from Federal sources	1,096	0
Change in unfilled customer orders		
Advance received	0	0
Without advance from Federal sources	207	161
Subtotal	247,724	216,393
Nonexpenditure transfers, net, anticipated and actual	(3,752)	(4,178)
Temporarily not available pursuant to Public Law	0	0
Permanently not available	(1,395)	(2,317)
Total Budgetary Resources	\$ <u>257,993</u>	\$ <u>236,108</u>

Department of Defense
Other Defense Organizations General Funds - Inspector General, Department of Defense
COMBINED STATEMENT OF BUDGETARY RESOURCES - Continued
For the Years Ended September 30
(Amounts in thousands)

	2008	2007
Status of Budgetary Resources:		
Obligations incurred:		
Direct	\$ 246,158	\$ 224,405
Reimbursable	1,340	250
Subtotal	<u>247,498</u>	<u>224,655</u>
Unobligated balance:		
Apportioned	3,052	2,901
Exempt from apportionment	0	0
Subtotal	<u>3,052</u>	<u>2,901</u>
Unobligated balance not available	7,443	8,552
Total status of budgetary resources	<u><u>\$ 257,993</u></u>	<u><u>\$ 236,108</u></u>
Change in Obligated Balance:		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	25,208	26,758
Less: Uncollected customer payments		
from Federal sources, brought forward, October 1	\$ (199)	\$ (38)
Total unpaid obligated balance	<u>25,008</u>	<u>26,720</u>
Obligations incurred net (+/-)	\$ 247,498	\$ 224,655
Less: Gross outlays	(236,415)	(215,578)
Obligated balance transferred, net		
Actual transfers, unpaid obligations (+/-)	0	0
Actual transfers, uncollected customer		
payments from Federal sources (+/-)	0	0
Total Unpaid obligated balance transferred, net	<u>0</u>	<u>0</u>
Less: Recoveries of prior year unpaid obligations, actual	(3,964)	(10,626)
Change in uncollected customer payments from Federal sources (+/-)	(1,303)	(161)
Obligated balance, net, end of period		
Unpaid obligations	32,326	25,208
Less: Uncollected customer payments (+/-)		
from Federal sources (-)	<u>(1,503)</u>	<u>(200)</u>
Total, unpaid obligated balance, net, end of period	30,823	25,008
Net Outlays		
Net Outlays:		
Gross outlays	236,415	215,578
Less: Offsetting collections	(32)	65
Less: Distributed Offsetting receipts	0	0
Net Outlays	<u><u>\$ 236,383</u></u>	<u><u>\$ 215,643</u></u>

Notes to the Basic Statements

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

1.A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Department of Defense Office of the Inspector General (DoD OIG), as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the DoD OIG in accordance with the DoD Financial Management Regulation, OMB Circular 136, *Financial Reporting Requirements*, and U.S. GAAP for Federal entities. The accompanying financial statements account for all resources for which the DoD OIG is responsible except that information relative to classified assets, programs, and operations has been excluded from the statements or otherwise aggregated and reported in such a manner that it is no longer classified. The DoD OIG's financial statements are in addition to the financial reports prepared pursuant to OMB directives that are used to monitor and control the use of budgetary resources.

1.B. Description of the Reporting Entity

The Department of Defense Inspector General (DoD Directive 5106.1), under the provisions set forth by Public Law 95-452, serves as an independent and objective official in the Department of Defense who is responsible for conducting, supervising, monitoring, and initiating audits, investigations, and inspections relating to programs and operations of the Department of Defense. The Inspector General provides leadership and coordination and recommends policies for activities designed to promote economy, efficiency, and effectiveness in the administration of, and to prevent and detect fraud and abuse in, such programs and operations. The Inspector General is also responsible for keeping the Secretary of Defense and the Congress fully informed about current problems and deficiencies relating to the administration of such programs and operations and the necessity for, and progress of, corrective action.

1.C. Appropriations

The DoD OIG's appropriations and funds are general funds. These appropriations and funds are used to support the resources that have been used in the course of executing the DoD OIG's mission. General funds are used for financial transactions arising under congressional appropriations, including, operation and maintenance, research and development, GWOT, BRAC and procurement accounts.

1.D. Basis of Accounting

The DFAS provides financial management services to the DoD OIG. Many of the DoD's financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of Federal GAAP for federal agencies. The DoD has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with all elements of GAAP for Federal entities. One such action is the current revision of its accounting systems to record transactions based on the United States Government Standard General Ledger (USSGL). Until such time as all of the DoD's General Funds financial and nonfinancial feeder systems and processes are updated to collect and report financial processes as required by GAAP for Federal entities, the DoD's financial data will be based on budgetary transactions (obligations, disbursements, and collections), transactions from nonfinancial feeder systems, and adjustments for known accruals of major items such as payroll expenses, accounts payable, and other accrued liabilities. However, these financial statements are presented on the accrual basis of accounting as required.

1.E. Revenues and Other Financing Sources

Financing sources for general funds are provided primarily through congressional appropriations that are received on both an annual and a multiyear basis. When authorized, these appropriations are supplemented by revenues generated by sales of goods or services through a reimbursable order process. The DoD OIG recognizes revenue as a result of costs incurred or services performed on behalf of other federal agencies and the public. Revenue is recognized when earned under the reimbursable order process.

1.F. Recognition of Expenses

For financial reporting purposes, the DoD policy requires the recognition of operating expenses in the period incurred. However, because the DoD OIG's financial and nonfinancial feeder systems were not designed to collect and record financial information on the full accrual accounting basis, accrual adjustments are made for major items such as payroll expenses and accounts payable. Expenditures for capital and other long-term assets are not recognized as expenses in the DoD OIG's operations until depreciated in the case of Property, Plant and Equipment (PP&E). Net increases or decreases in unexpended appropriations are recognized as a change in the net position. Certain expenses, such as annual and military leave earned but not taken, are financed in the period in which payment is made.

1.G. Accounting for Intra-governmental Activities

The DoD OIG, as an agency of the Federal government, interacts with and is dependent upon the financial activities of the Federal government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to the DoD OIG as though the agency was a stand-alone entity.

The DoD OIG's proportionate share of public debt and related expenses of the Federal government are not included. Debt issued by the federal government and the related costs are not apportioned to federal agencies. The DoD OIG's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

The DoD OIG's civilian employees participate in the Civil Service Retirement System (CSRS) and the Federal Employees Retirement Systems (FERS), while military personnel are covered by the Military Retirement System (MRS). Additionally, employees and personnel covered by FERS and MRS also have varying coverage under Social Security. The DoD OIG funds a portion of the civilian and military pensions. Reporting civilian pensions under CSRS and FERS retirement systems is the responsibility of the Office of Personnel Management (OPM). The DoD OIG recognizes an imputed expense for the portion of civilian employee pensions and other retirement benefits funded by the OPM in the Statement of Net Cost and recognizes corresponding imputed revenue from the civilian employee pensions and other retirement benefits in the Statement of Changes in Net Position.

1.H. Funds with the U.S. Treasury

The DoD OIG's financial resources are maintained in U.S. Treasury accounts. The collections, disbursements, and adjustments are processed at the DFAS disbursing stations. Each disbursing station prepares monthly reports, which provide information to the U.S. Treasury on check issues, electronic fund transfers, interagency transfers and deposits.

In addition, the DFAS sites submit reports to the Department of the Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Department of the Treasury then records this information to the applicable Fund Balance with Treasury (FBWT) account maintained in the Treasury's system. Differences between the DoD OIG's recorded balance in the FBWT accounts and Treasury's FBWT accounts sometimes occur and are subsequently reconciled.

1.I. Accounts Receivable

Accounts receivable includes accounts, claims, and refunds receivable from other federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The DoD OIG does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are resolved between the agencies.

1.J. Use of Estimates

The preparation of financial statements requires management to make certain estimates and assumptions that affect the reported amount of assets and liabilities, at the date of the

financial statements, and the amount of revenues and costs reported during the period. Actual results could differ from those estimates.

1.K. Other Assets

Other Assets are classified as assets which are not reported elsewhere on the Balance Sheet, such as military and civil service employee pay advances, travel advances, and certain contract financing payments.

Business is conducted with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor caused by long-term contracts, financing payments may be provided. Federal Acquisition Regulations, Part 32, defines contract financing payments as authorized disbursements of monies to a contractor prior to acceptance of supplies or services by the Government. Contract financing payments clauses are incorporated in the contract terms and conditions and may include advance payments, performance-based payments, commercial advance and interim payments, progress payments based on cost, and interim payments under certain cost-reimbursement contracts.

Contract financing payments do not include invoice payments, payments for partial deliveries, lease and rental payments, or progress payments based on a percentage or stage of completion, which the Defense Federal Acquisition Regulation Supplement authorizes only for construction of real property, shipbuilding, and ship conversion, alteration, or repair. Progress payments for real property and ships are reported as Construction in Progress. It is DoD policy to record certain contract financing payments as Other Assets.

1.L. General Property, Plant and Equipment

General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years, and when the acquisition cost equals or exceeds the DoD capitalization threshold of \$100,000. Also, improvement costs over the DoD capitalization threshold of \$100,000 for General PP&E are required to be capitalized. All General PP&E is depreciated on a straight-line basis.

Government property is provided to contractors to complete their work when it is in the best interest of the Government. The DoD OIG either owns or leases such property, or it is purchased directly by the contractor for the Government based on contract terms. When the value of contractor-procured General PP&E exceeds the DoD capitalization threshold, Federal accounting standards require that it be reported on the DoD OIG's Balance Sheet.

1.M. Advances and Prepayments

Payments in advance of the receipt of goods and services are recorded as advances or prepayments and reported as assets on the Balance Sheet. Advances and prepayments are

recognized as expenditures and expenses when the related goods and services are received.

1. N. Leases

Generally, lease payments are for the rental of equipment and operating facilities and are classified as either capital or operating leases. When a lease is essentially equivalent to an installment purchase of property (a capital lease) and the value equals or exceeds the current DoD capitalization threshold, the applicable asset and liability are recorded. The amount recorded is the lesser of the present value of the rental and other lease payments during the lease term, excluding that portion of the payments representing executory costs paid to the lessor, or the asset's fair value. Leases that do not transfer substantially all of the benefits or risks of ownership are classified as operating leases and recorded as expenses as payments are made over the lease term.

1.O. Contingencies and Other Liabilities

The SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss to the DoD OIG. The uncertainty will be resolved when one or more future events occur or fail to occur. A contingency is recognized as a liability when a past event or exchange transaction has occurred, a future loss is probable and the amount of loss can be reasonably estimated. Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility that a loss or additional loss will be incurred.

1.P. Accrued Leave

Civilian annual leave and military leave that have been accrued and not used as of the balance sheet date are reported as liabilities. The liability reported at the end of the fiscal year reflects the current pay rates.

1.Q. Net Position

Net Position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations represent amounts of authority, which are unobligated and have not been rescinded or withdrawn, and amounts obligated but for which legal liabilities for payments have not been incurred.

Cumulative results of operations represent the balances that result from subtracting expenses and losses, from financing sources including appropriations, revenue, and gains since the inception of the activity.

1.R. Undelivered Orders

The DoD OIG records obligations for goods and services that have been ordered but not yet received. No liability for payment has been established in the financial statements because goods or services have yet to be delivered.

NOTE 2. NONENTITY ASSETS

As of September 30	2008	2007
(Amounts in thousands)		
1. Intragovernmental Assets		
A. Fund Balance with Treasury	\$ 0	0
B. Total Intragovernmental Assets	\$ 0	\$ 0
2. Nonfederal Assets		
A. Cash and Other Monetary Assets	\$ 85	\$ 0
B. Total Nonfederal Assets	\$ 85	\$ 0
3. Total Nonentity Assets	\$ 85	\$ 0
4. Total Entity Assets	\$ 42,776	\$ 36,776
5. Total Assets	\$ 42,861	\$ 36,776

Asset accounts are categorized either as entity or nonentity. Entity accounts consist of resources that the agency has the authority to use, or funds that management is legally obligated to use to meet entity obligations. Nonentity accounts are assets that are held by an entity, but are not available for use in the operations of the entity.

Seized cash in the amount of \$85 thousand is reported. The cash resulted from DCIS operations and is held in evidence lockers pending court proceedings. Depending on the outcome of the trial, this money can either be returned to the original owner or deposited in Treasury's accounts.

NOTE 3. FUND BALANCE WITH TREASURY

As of September 30	2008	2007
(Amounts in thousands)		
1. Fund Balances		
A. Appropriated Funds	\$ 41,319	\$ 36,461
B. Total Fund Balances	\$ 41,319	\$ 36,461
2. Fund Balances Per Treasury Versus Agency		
A. Fund Balance per Treasury	\$ 42,714	\$ 37,947
B. Fund Balance per Agency	41,319	36,461
3. Reconciling Amount	\$ (1,395)	\$ (1,486)

DoD OIG uses Treasury Index 97. The Department of Treasury (Treasury) reports fund balances at the appropriation basic symbol level. The DoD OIG funding is allotted at limit level.

STATUS OF FUND BALANCE WITH TREASURY

As of September 30	2008	2007
(Amounts in thousands)		
1. Unobligated Balance		
A. Available	\$ 3,053	\$ 2,901
B. Unavailable	7,443	8,552
2. Obligated Balance not yet Disbursed	\$ 32,326	\$ 25,208
3. Non-Budgetary FBWT \$	\$ 0	0
4. Non-FBWT Budgetary Accounts	\$ (1,503)	\$ (200)
5. Total	\$ 41,319	\$ 36,461

The DoD OIG did not have any suspense or budget clearing accounts to report at September 30, 2008.

NOTE 4. ACCOUNTS RECEIVABLE

As of September 30	2008			2007
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
(Amounts in thousands)				
1. Intra-governmental Receivables	\$ 1,096	N/A	\$ 1,096	\$ 0
2. Nonfederal Receivables (From the Public)	\$ 108	\$ 0	\$ 108	\$ 62
3. Total Accounts Receivable	<u>\$ 1,204</u>	<u>\$ 0</u>	<u>\$ 1,204</u>	<u>\$ 62</u>

NOTE 5. CASH AND OTHER MONETARY ASSETS ²

As of September 30	2008	2007
(Amounts in thousands)		
1. Cash	\$ 85	\$ 0
2. Total Cash, Foreign Currency, & Other Monetary Assets	<u>\$ 85</u>	<u>\$ 0</u>

The \$85 thousand represents cash seized as a result of DCIS operations. This amount is currently being held pending court proceedings and can either be returned to the original owner or deposited in Treasury's accounts.

² This note discloses restricted cash under the control of the reporting entity but unavailable for agency use (non-entity cash) and has not been transferred to the general fund.

NOTE 6. OTHER ASSETS

As of September 30	2008	2007
(Amounts in thousands)		
1. Intragovernmental Other Assets		
A. Advances and Prepayments	\$ 0	\$ 0
B. Other Assets	0	0
C. Total Intragovernmental Other Assets	\$ 0	\$ 0
2. Nonfederal Other Assets		
A. Other Assets (With the Public)	253	253
B. Total Nonfederal Other Assets	\$ 253	\$ 253
3. Total Other Assets	\$ 253	\$ 253

NOTE 7. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

As of September 30	2008	2007
(Amounts in thousands)		
1. Intragovernmental Liabilities		
A. Accounts Payable	\$ 0	\$ 0
B. Debt	0	0
C. Other	1,918	1,668
D. Total Intragovernmental Liabilities	\$ 1,918	\$ 1,668
2. Nonfederal Liabilities		
A. Accounts Payable	\$ 0	\$ 0
B. Military Retirement and Other Federal Employment Benefits	7,463	6,678
C. Other Liabilities	14,363	12,358
D. Total Nonfederal Liabilities	\$ 21,826	\$ 19,036
3. Total Liabilities Not Covered by Budgetary Resources	\$ 23,744	\$ 20,704
4. Total Liabilities Covered by Budgetary Resources	\$ 11,902	\$ 10,921
5. Total Liabilities	\$ 35,646	\$ 31,625

Liabilities Not Covered by Budgetary Resources

Liabilities that are not considered covered by budgetary resources as of the Balance Sheet date. Budgetary resources encompass the following:

- New budget authority;
- Spending authority from offsetting collections (credited to an appropriation or fund account);
- Recoveries of unexpired budget authority through downward adjustments of prior-year obligations;
- Unobligated balances of budgetary resources at the beginning of the year or net transfers of prior-year balances during the year; and
- Borrowing authority or permanent indefinite appropriations, which have been enacted and signed into law as of the balance sheet date, provided that the resources may be apportioned by the OMB without further action by the Congress or without a contingency first having to be met.

Liabilities Covered by Budgetary Resources

Resources incurred by the reporting entity, which are covered by realized budget resources as of the balance sheet date. Budgetary resources encompass not only new budget authority, but also other resources available to cover liabilities for specified purposes in a given year. Available budgetary resources include the following:

- New budget authority;
- Spending authority from offsetting collections (credited to an appropriation or fund account);
- Recoveries of unexpired budget authority through downward adjustments of prior year obligations; and
- Unobligated balances of budgetary resources at the beginning of the year or net transfers of prior-year balances during the year.

NOTE 8. ACCOUNTS PAYABLE

As of September 30	2008			2007
	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
(Amounts in thousands)				
1. Intragovernmental Payables	\$ 1,601	\$ N/A	\$ 1,601	\$ 3,303
2. Nonfederal Payables (to the Public)	1,780	0	1,780	1,303
3. Total	\$ 3,381	\$ 0	\$ 3,381	\$ 4,606

Intragovernmental accounts payable consists of amounts owed to other federal agencies for good or services ordered and received but not yet paid. Interest, penalties and administrative fees are not applicable to intragovernmental payables. Non-federal payables (to the public) include payments to nonfederal government entities.

NOTE 9. MILITARY RETIREMENT AND OTHER FEDERAL EMPLOYMENT BENEFITS

As of September 30	2008				2007
	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liability	Present Value of Benefits
(Amounts in thousands)					
1. Pension and Health Actuarial Benefits					
A. Military Retirement Pensions	\$ 0		\$ 0	\$ 0	\$ 0
B. Military Retirement Health Benefits	0		0	0	0
C. Military Medicare-Eligible Retiree Benefits	0		0	0	0
D. Total Pension and Health Actuarial Benefits	\$ 0		\$ 0	\$ 0	\$ 0
2. Other Actuarial Benefits					
A. FECA	\$ 7,463		\$ 0	\$ 7,463	\$ 6,678
B. Voluntary Separation Incentive Programs	0		0	0	0
C. DoD Education Benefits Fund	0		0	0	0
D. Total Other Actuarial Benefits	\$ 7,463		\$ 0	\$ 7,463	\$ 6,678
3. Other Federal Employment Benefits					
	\$ 0		\$ 0	\$ 0	\$ 0
4. Total Military Retirement and Other Federal Employment Benefits:					
	\$ 7,463		\$ 0	\$ 7,463	\$ 6,678

Federal Employees Compensation Act (FECA)

The actuarial liability for workers' compensation benefits is developed by the Department of Labor and provided to the DoD OIG at the end of each fiscal year. The liability includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability is determined by using historical benefit payment patterns to predict the future payments. Cost-of-living adjustments and medical inflation factors are also included in the calculation of projected future benefits. Consistent with past practices, these projected annual benefit payments are then discounted to present value using the OMB economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

Year 1	4.368%
Year 2 and thereafter	4.770%

To provide more specificity for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors (Cost-of-Living Adjustments or COLAs) and medical inflation factors (Consumer Price Index-Medical, or CPIMs) were applied to the calculation of projected future benefits. These factors were also used in adjusting the methodology's historical payments to current year constant dollars.

The compensation COLAs and CPIMs used in the projections for various charge back years (CBY) were as follows:

<u>CBY</u>	<u>COLA</u>	<u>CPIM</u>
2009	3.87%	4.01%
2010	2.73%	3.86%
2011	2.20%	3.87%
2012	2.23%	3.93%
2013+	2.30%	3.93%

The model's resulting projections were critically analyzed to ensure that the estimates were reliable. The analysis was primarily based on two tests: 1) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments, and 2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year, as calculated for the current projection to the liability-payment ratio calculated for the prior projection.

NOTE 10. OTHER LIABILITIES

As of September 30	2008			2007
	Current Liability	Noncurrent Liability	Total	Total
(Amounts in thousands)				
1. Intragovernmental				
A. Advances from Others	\$ 0	\$ 0	\$ 0	\$ 0
B. Deposit Funds and Suspense Account Liabilities	0	0	0	0
C. FECA Reimbursement to the Department of Labor	0	1,918	1,918	1,668
D. Other Liabilities	1,260	0	1,260	917
E. Total Intragovernmental Other Liabilities	\$ 1,260	\$ 1,918	\$ 3,178	\$ 2,585
2. Nonfederal				
A. Accrued Funded Payroll and Benefits	\$ 6,469	\$ 0	\$ 6,469	\$ 4,850
B. Advances from Others	0	0	0	0
C. Deferred Credits	0	0	0	0
D. Deposit Funds and Suspense Accounts	0	0	0	0
E. Temporary Early Retirement Authority	0	0	0	0
F. Accrued Unfunded Annual Leave	14,280	0	14,280	12,358
G. Capital Lease Liability	0	0	0	0
H. Other Liabilities	875	0	875	549
I. Total Nonfederal Other Liabilities	\$ 21,624	\$ 0	\$ 21,624	\$ 17,757
3. Total Other Liabilities	\$ 22,884	\$ 1,918	\$ 24,802	\$ 20,342

NOTE 11. GENERAL DISCLOSURES RELATED TO THE STATEMENT OF NET COST

Intragovernmental Costs and Exchange Revenue		
As of September 30	2008	2007
(Amounts in thousands)		
1. Intragovernmental Costs	\$ 52,873	\$ 50,610
2. Public Costs	196,916	179,364
3. Total Costs	\$ 249,789	\$ 229,974
4. Intragovernmental Earned Revenue	\$ (1,128)	\$ 0
5. Public Earned Revenue	0	65
6. Total Earned Revenue	\$ (1,128)	\$ 65
7. Net Cost of Operations	\$ 248,661	\$ 230,039

Disclosures Related to the Statement of Net Cost

The Consolidated Statement of Net Cost (SNC) in the Federal government is unique because its principles are driven on understanding the net cost of programs and/or organizations that the Federal government supports through appropriations or other means. This statement provides gross and net cost information that can be related to the amount of output or outcome for a given program and/or organization administered by a responsible reporting entity.

NOTE 12. DISCLOSURES RELATED TO THE STATEMENTS OF CHANGES IN NET POSITION

As of September 30	2008		2007	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
(Amounts in thousands)				
Prior Period Adjustments Increases (Decreases) to Net Position Beginning Balance				
A. Changes in Accounting Standards	\$ 0	\$ 0	\$ 0	\$ 0
B. Errors and Omissions in Prior Year Accounting Reports	0	0	0	0
C. Total Prior Period Adjustments	\$ 0	\$ 0	\$ 0	\$ 0
2. Imputed Financing				
A. Civilian CSRS/FERS Retirement	\$ 3,083	\$ 0	\$ 4,000	\$ 0
B. Civilian Health	6,329	0	6,753	0
C. Civilian Life Insurance	25	0	23	0
D. IntraEntity	0	0	0	0
E. Total Imputed Financing	\$ 9,437	\$ 0	\$ 10,776	\$ 0

Other Information:**Imputed Financing**

The amounts remitted to the Office of Personnel Management (OPM) by and for employees covered by the Civil Service Retirement System (CSRS), Federal Employee Retirement System (FERS), Federal Employees Health Benefits (FEHB) Program and the Federal Employee Group Life Insurance (FEGLI) Program do not fully cover the Government's cost to provide these benefits. An imputed cost is recognized as the difference between the Government's cost of providing these benefits and employee contributions made by and for them. The OPM provides the cost factors to the Defense Finance and Accounting Service (DFAS) for computing imputed financing costs. The DFAS provides computed costs to the Office of the Under Secretary of Defense (Personnel and Readiness) (OUSDP&R)) for validation and approval. The official imputed costs are then provided to the reporting components for inclusion in their financial statements.

NOTE 13. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

As of September 30	2008	2007
(Amounts in thousands)		
1. Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ 20,678	\$ 14,539
2. Available Borrowing and Contract Authority at the End of the Period	0	0

Apportionment Categories

(Amount in thousands)

Direct Obligations

Category A	\$219,978
Category B	<u>0</u>
Total Direct Obligations	\$219,978
Exempt from Apportionment	\$0
Reimbursable Obligations	<u>\$1,336</u>
Total Obligations	<u>\$221,314</u>

Information Related to the Statement of Budgetary Resources

Undelivered Orders presented in the Statement of Budgetary Resources (SBR) include Undelivered Orders-Unpaid for both direct and reimbursable funds.

Adjustments to funds that are temporarily not available pursuant to Public Law and adjustments to funds that are permanently not available (included in the Adjustments line on the SBR) are not included in the Spending Authority from Offsetting Collections and Adjustments line on the

SBR nor on the Spending Authority for Offsetting Collections and Adjustments line on the Statement of Financing.

NOTE 14. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

As of September 30	2008	2007
(Amounts in thousands)		
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
1. Obligations incurred	\$ 247,498	\$ 224,655
2. Less: Spending authority from offsetting collections and recoveries (-)	(5,300)	(10,723)
3. Obligations net of offsetting collections and recoveries	\$ 242,198	\$ 213,932
4. Less: Offsetting receipts (-)	0	0
5. Net obligations	\$ 242,198	\$ 213,932
Other Resources:		
6. Donations and forfeitures of property	0	0
7. Transfers in/out without reimbursement (+/-)	0	0
8. Imputed financing from costs absorbed by others	9,437	10,776
9. Other (+/-)	46	13
10. Net other resources used to finance activities	\$ 9,483	\$ 10,789
11. Total resources used to finance activities	\$ 251,681	\$ 224,721
Resources Used to Finance Items not Part of the Net Cost of Operations:		
12. Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
12a. Undelivered Orders (-)	\$ (6,139)	\$ 3,567
12b. Unfilled Customer Orders	208	161
13. Resources that fund expenses recognized in prior Periods (-)	0	0
14. Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	0	0
15. Resources that finance the acquisition of assets (-)	0	0
16. Other resources or adjustments to net obligated resources that do not affect Net Cost of Operations:		
16a. Less: Trust or Special Fund Receipts Related to exchange in the Entity's Budget (-)	0	0
16b. Other (+/-)	(46)	(13)
17. Total resources used to finance items not part of the Net Cost of Operations	\$ (5,977)	\$ 3,715
18. Total resources used to finance the Net Cost of Operations	\$ 245,704	\$ 228,436
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		

Components Requiring or Generating Resources in Future Period:			
19. Increase in annual leave liability	\$	1,921	\$ 1,307
20. Increase in environmental and disposal liability		0	0
21. Upward/Downward reestimates of credit subsidy expense (+/-)		0	0
22. Increase in exchange revenue receivable from the public (-)		0	0
23. Other (+/-)		1,036	296
24. Total components of Net Cost of Operations that will Require or Generate Resources in future periods	\$	2,957	\$ 1,603
25. Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	\$	2,957	\$ 1,603
26. Net Cost of Operations	\$	248,661	\$ 230,039

Components of the Net Cost of Operations that will not Require or Generate Resources in Future Period:

The objective of the Statement of Financing is to reconcile the difference between budgetary obligations and the net cost of operations reported. The OMB Circular A-136 requires the Statement of Financing to be presented on a consolidated basis in the Reconciliation of Net Cost of Operations.

The following Statement of Financing lines are presented as combined instead of consolidated due to interagency budgetary transactions not being eliminated:

- Obligations Incurred
- Less: Spending Authority from Offsetting Collections and Recoveries
- Obligations Net of Offsetting Collections and Recoveries
- Less: Offsetting Receipts
- Net Obligations
- Undelivered Orders
- Unfilled Customer Orders

The Other line in Resources Used to Finance Activities consists of other gains and losses.

The Other line in Resources Used to Finance Items not Part of the Net Cost of Operations consists of other gains and losses.

The Other line in Components Requiring or Generating Resources in Future Period section consists of future funded expenses for unfunded leave.

The Other line in Components of the Net Cost of Operation that will not Require or Generate Resources in the Current Period consists of cost capitalization offset.

NOTE 15. DISCLOSURES RELATED TO INCIDENTAL CUSTODIAL COLLECTIONS

In accordance with the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, *Accounting for Inventory and Related Property*, and OMB Circular A-136, property seized with a total value of \$2.165 million is reported.

FY 2008 is the initial reporting period of seized assets; therefore the table below includes activity for FY 2008 only.

The reported assets consist of cash, hardware/software, military equipment, miscellaneous, and non-valued items seized during investigations of major procurement fraud, cyber crimes, healthcare fraud, public corruption, anti-terrorism operations, and technology protection investigations (illegal transfer, theft, or diversion of DoD technologies and U.S. Munitions List items to proscribed nations and persons).

Seized property is not considered an asset and is not reported as such in the financial statements. However, the DoD OIG has a stewardship responsibility until the disposition of the seized items are determined, i.e., judicially or administratively forfeited or returned to the entity from which it was seized. The values assigned to the seized property are determined by each DCIS agent and are based on fair market values for comparable property. A \$2,500 threshold was established to aggregate all activity for the year.

The following table describes the categories of seized assets and the respective value as of September 30, 2008:

Seized Property (Amounts in thousands)										
Fiscal Year Ended September 30, 2008										
Seized Category:	Beginning Balance		New Seizures		Remissions		Adjustments		Ending Balance	
	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value	Quantity	Value
Cash/Monetary Instruments										
Cash/U.S. Currency										\$85
Monetary Instruments									1	0 ³
Subtotal									1	\$85
Personal Property - Government										
Hardware/software									49	\$43
Vehicles									6	980
Military Equipment									1,074	924
Miscellaneous									4	16
Subtotal									1,133	\$1,963
Personal Property -Non Government										
Jewelry									6	59
Computer/hardware									59	8
Miscellaneous									41	51
Subtotal									106	\$118
Non Valued Assets (in number of items)										
Firearms									551	\$0
Documents (Papers, Logs, binders, files, etc)									2,417	0
Media Storage (Disks, tapes, CDs, microfiche, etc)									2,414	0
Boxes (Various Items)									136	0
Electronics, Hardware									625	0
Miscellaneous Items									178	0
Subtotal									6,321	\$0
Grand Total									7,561	\$2,165

³ Monetary Instrument consist of one \$500.00 Money Order.

NOTE 16. OTHER DISCLOSURES

As of September 30	2008			
	Asset Category			
	Land and Buildings	Equipment	Other	Total

(Amounts in thousands)

**1. ENTITY AS LESSEE-
Operating Leases**

Future Payments Due

Fiscal Year

2009	\$	18,512	\$	0	\$	0	\$	18,512
2010		17,511		0		0		17,511
2011		16,362		0		0		16,362
2012		8,799		0		0		8,799
2013		2,993		0		0		2,993
After 5 Years		9,032		0		0		9,032

**Total Future
Lease Payments
Due**

	\$	73,209	\$	0	\$	0	\$	73,209
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Other Information – According to the FMR Volume 6B, Chapter 10, the Inspector General must disclose information relating to operating leases such as the existence and terms of renewal options, escalation clauses, restrictions imposed by lease agreements, contingent rental and the lease period. We projected fiscal years FY09 to FY13 and five years after. Our calculations were based on current expiration of lease agreements shown in the GSA website.

Office buildings in the amount of \$73.2 million represent office space rental. The lease periods are from three to ten years. There are no escalation clauses or contingent rental restrictions.

Appendix A – DoD OIG Management’s Comments On the Auditors’ Report



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

November 3, 2008

MEMORANDUM FOR ACUITY CONSULTING, INC

SUBJECT: Draft Report of the Office of the Inspector General, Department of Defense
FY 2008 Financial Statement Audit.

The Office of the Inspector General, Department of Defense is providing the attached general comments to the material weaknesses identified during the FY 2008 Financial Statement audit.

The point of contact is Mr. Marlon Moreira. Mr. Moreira can be reached at (703) 602-2226.

A handwritten signature in black ink, appearing to read "W. M. Culbreth", is located above the typed name.

W. M. Culbreth
Comptroller

Attachment:
As stated

Auditor's Comment:

The DoD OIG does not perform adequate managerial review of the information processed by DFAS

In the prior year, we observed that the DoD OIG performed many activities that replicate the actions taken by their service provider. In some cases the activities are more akin to converting data from one format to another (i.e. PDF to Excel). In the current year, business processes are in place to independently validate the information being processed by the service provider. These processes need to continue, in order to assure that data analysis of the financial reporting level is performed.

Management Comments:

The DoD OIG concurs with this comment. The Office of the Comptroller will maintain and improve these processes, in order to assure that data analysis of the financial reporting level is performed. In addition, the Office of the Comptroller will continue to work with DFAS Indianapolis to properly review transactions that may affect the DoD OIG's Financial Statements.

Auditor's Comment:

The DoD OIG does not have a process in place to ensure the completeness of the quarterly or year-end financial statements

In prior years we reported, and the condition continues in need of remediation, that the DoD OIG in conjunction with their service provider has not fully documented the crosswalks used to develop the DD 1176 from the WAAS general ledger. The DD 1176 serves as an integral piece of the audit trail from the general ledger to the Statement of Budgetary Resources. The DoD OIG did, however, adopt an interim process using alternative procedures by which we were able to validate the DD 1176 and the statement of budgetary resources. Additional actions are necessary to fully remediate this condition.

Management Comments:

The DoD OIG concurs with this comment. The Office of the Comptroller adopted an interim process using alternative procedures to properly reconcile and validate the DD 1176 report produced by DFAS. The DoD OIG will continue to work with DFAS Indianapolis to develop an Access database to fully account for every reported amount in our DD 1176.

Auditor's Comment:

The DoD OIG does not have fundamental processes in place to ensure that transactions initiated are appropriately reviewed and approved.

We continued to observe that the DoD OIG does not have fully implemented business practices to perform adequate management review of transactions recorded to their books. In prior years, we observed newly implemented business processes to review the

validity of lease or facilities costs recorded; however, in the current year there was limited progress on the development of policy and the refinement of processes to validate the amounts recorded for logistical support costs. The DoD OIG needs to identify, develop and implement management review and validation techniques to enable them to fulfill their management stewardship responsibilities.

Management Comments:

The DoD OIG concurs with this comment. The Office of the Comptroller will assist the Administration & Logistics Services Directorate to develop policies and processes to validate the amounts recorded for logistical support costs. Moreover, the Office of the Comptroller will continue to work with the components to implement adequate independent validation processes to improve our current analysis of information at the financial reporting level.

