

# **Independent Auditors' Report on the Principal Statements**

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INSPECTOR GENERAL  
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November 12, 2004

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE  
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

SUBJECT: Independent Auditor's Report on the Fiscal Year 2004 DoD Agency-Wide  
Financial Statements (Report No. D-2005-017)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires Federal agency Inspectors General appointed under the Inspector General Act of 1978, as amended, to audit their respective agency's financial statements or determine that "an independent external auditor" should conduct such audits. Pursuant to this statutory authority, the undersigned Inspector General of the Department of Defense assumed responsibility for auditing the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2004 and 2003, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Combined Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended.

The financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the Fiscal Year 2004 financial statements of DoD because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance With Laws and Regulations. The Report on Internal Control and Compliance With Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

**Disclaimer of Opinion on the Financial Statements**

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that (1) the FY 2004 DoD Agency-Wide Financial Statements would not substantially conform to generally accepted accounting principles and (2) DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2004. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Inspector General of the Department of Defense to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. DoD has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." - Constitution of the United States, Article I, Section 9

affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial statements.<sup>1</sup> As described above, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

### Summary of Internal Control

In planning our audit, we considered DoD internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance. However, previously identified reportable conditions,<sup>2</sup> all of which are material, continued to exist in the following areas:

- Financial Management Systems;
- Fund Balance with Treasury;
- Inventory;
- Operating Materials and Supplies;
- General Property, Plant, and Equipment (PP&E);
- Government-Furnished Material and Contractor-Acquired Material;
- Environmental Liabilities;
- Intragovernmental Eliminations;
- Other Accounting Entries;
- Statement of Net Cost; and
- Statement of Financing.

A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance that are material in relation to the financial statements would be prevented or detected on a timely basis. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

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<sup>1</sup> The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

<sup>2</sup> Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

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## Summary of Compliance With Laws and Regulations

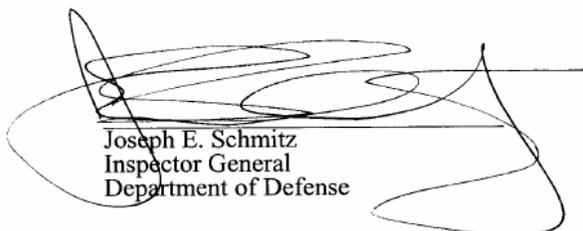
Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that DoD financial management systems do not comply substantially with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether DoD was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with laws and regulations.

## Management Responsibility

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met; and
- complying with applicable laws and regulations.

We provided a draft of this report to personnel in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer who provided technical comments, which have been incorporated as appropriate. These officials expressed their continuing commitment to address the problems this report outlines.



Joseph E. Schmitz  
Inspector General  
Department of Defense



Paul J. Granetto, CPA  
Assistant Inspector General  
Defense Financial Auditing Service

Attachment:  
As stated

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## **Report on Internal Control and Compliance With Laws and Regulations**

### **Internal Control**

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, management acknowledged that previously identified reportable conditions, all of which are material, continue to exist. The following financial management deficiencies are indications of material weaknesses in internal control that may adversely affect any decision by DoD that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by DoD also may contain misstatements resulting from these deficiencies.

**Financial Management Systems.** Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting," requires financial management systems controls that are adequate to ensure that transactions are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards. SFFAC No. 1 also requires that financial management systems controls ensure that assets are properly safeguarded to deter fraud, waste, and abuse; and that performance measurement information is adequately supported. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged that many DoD financial management systems do not substantially comply with Federal financial management systems requirements. DoD financial management and feeder systems were not designed to adequately support various material amounts on the financial statements. These systemic deficiencies in financial management and feeder systems and inadequate DoD business processes result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.

**Fund Balance with Treasury.** DoD is required by the Treasury Financial Manual and DoD Financial Management Regulation 7000.14-R, to resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury. However, inconsistencies continue to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, unreconciled differences in suspense accounts, and unreconciled differences between U.S. Treasury records and DoD accounting records.

**Inventory.** DoD is required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," to use historical cost or the latest acquisition cost adjusted for holding gains and losses or moving average cost for valuing Inventory. However, DoD acknowledged that the existing inventory valuation at most activities does not

Attachment

approximate historical cost. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by SFFAS No. 3.

**Operating Materials and Supplies.** SFFAS No. 3 also states that Operating Materials and Supplies must be expensed when the items are consumed. DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when they were consumed. In addition, DoD acknowledged that significant amounts of Operating Materials and Supplies in the possession of contractors were not included in the Operating Materials and Supplies account balance.

**General Property, Plant, and Equipment.** DoD is required by SFFAS No. 6, "Accounting for Property, Plant, and Equipment," to record PP&E at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, DoD has acknowledged that it is unable to accurately report the value of PP&E on its financial statements. DoD legacy property and logistic systems were not designed to capture acquisition cost, costs of modifications and upgrades, or calculate depreciation. In addition, value of DoD PP&E is not reliably reported because of a lack of supporting documentation.

**Government-Furnished Material and Contractor-Acquired Material.** SFFAS No. 11, "Amendments to Accounting for Property, Plant, and Equipment," requires that property and equipment in the possession of a contractor for use in accomplishing a contract be considered Government property. Government property should be accounted for based on the nature of the item, regardless of who has possession. DoD has acknowledged, and prior audits confirm, that it is unable to comply with applicable requirements for Government-Furnished Materials and Contractor Acquired-Materials. As a result, the value of DoD property and material in the possession of contractors is not reliably reported.

**Environmental Liabilities.** DoD acknowledged that guidance and audit trails for estimating environmental liabilities are incomplete. Environmental liability estimates were unreliable because activities did not have effective controls in place to ensure that adequate audit trails and supporting documentation for estimates exist, and that they comply with established guidance in developing estimates and maintain reliable feeder and coordination systems. In addition, material uncertainties exist related to environmental cleanup because of incomplete documentation for cleanup costs.

**Intragovernmental Eliminations.** DoD acknowledged that it made unverifiable adjustments because of the inability to reconcile most intragovernmental transactions. For example, the Defense Finance and Accounting Service-Indianapolis entered more than \$59 billion in unsupported adjustments to Army intragovernmental accounts to bring them into agreement with related amounts reported by its trading partners.

**Other Accounting Entries.** DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, the Defense Finance and Accounting Service-Indianapolis recorded \$204.8 billion (excluding adjustments for intragovernmental transactions) in unsupported accounting entries to prepare the FY 2004 Army General Fund Financial Statements.

Attachment

**Statement of Net Cost.** SFFAC No. 2, “Entity and Display,” requires the Statement of Net Cost to provide an understanding of the net costs of each organization and each program. In addition, the Statement of Net Cost should provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and/or organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost.

- The amounts presented for General Funds may not report actual accrued costs.
- Although the funds are generally recorded on an accrual basis for Working Capital Funds, as is required by generally accepted accounting principles, the systems do not always capture actual costs in a timely manner.
- Current financial processes and systems do not capture and report accumulated costs for major programs based on performance measures as required by the Government Performance and Results Act.
- DoD accounting systems do not capture cost data in a manner that enables DoD to determine if the costs were incurred to generate intragovernmental revenue.
- DoD accounting systems do not capture trading partner data at the transaction level in a manner that facilitates trading partner aggregations. Consequently, DoD was unable to reconcile intra-governmental revenue balances with its trading partners.

**Statement of Financing.** SFFAS No. 7, “Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,” states that the Statement of Financing should reconcile resources obligated during the period to the net cost of operations. However, DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making adjustments. Specifically, budgetary data are not in agreement with proprietary expenses. DoD disclosed in Note 22 that the Statements of Financing and Net Cost were adjusted by \$10,071.7 million (absolute value) to bring them into agreement. Lastly, DoD presented the Statement of Financing on a combined basis instead of a consolidated basis as required by Office of Management and Budget (OMB) Bulletin No. 01-09, “Form and Content of Agency Financial Statements.”

### **Compliance With Laws and Regulations**

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continued to exist. Therefore, we did not determine whether DoD was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

Attachment

**Statutory Financial Management Systems Reporting Requirements.** DoD is required to comply with the following financial management systems reporting requirements.

- Section 3512, title 31, United States Code, incorporates the reporting requirements of the FMFIA of 1982 and requires DoD to evaluate its systems and to annually report whether those systems are in compliance with requirements prescribed by the Comptroller General.
- The Federal Financial Management Improvement Act (FFMIA) of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The FFMIA also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management systems requirements. The remediation plan is to include remedies, resources required, and milestones.

For FY 2004, DoD did not fully comply with the statutory reporting requirements identified in these provisions. Specifically, DoD acknowledged that many of its critical financial management and feeder systems did not comply substantially with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2004. In an attempt to remedy these long-standing financial management systems deficiencies, DoD is developing a DoD-Wide Business Enterprise Architecture. However, the Business Enterprise Architecture falls short of meeting the requirements of a remediation plan under the FFMIA because the architecture does not identify the resources required to correct the noncompliance with Federal financial management system requirements. Until the architecture is fully developed and implemented, DoD will continue to be unable to fully comply with the statutory reporting requirements. We did not perform tests of compliance for these requirements.

**Antideficiency Act.** Title 31, section 1341 of the United States Code states that an officer or employee of the United States Government may not “make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund for the expenditure or obligation;” or “involve either government in a contract or obligation for the payment of money before an appropriation is made unless otherwise authorized by law.” During FY 2004 DoD completed 33 investigations of potential violations of the Antideficiency Act, and determined that 21 were actual violations.

In response to violations of the Antideficiency Act, title 31, sections 1351 and 1349 require DoD to immediately report the nature of violations to the President and Congress and to take appropriate disciplinary action against those responsible for the violations. In a recent audit of Antideficiency Act cases closed in FYs 2002 and 2003,<sup>3</sup> we identified that DoD was not reporting Antideficiency Act violations to the President and Congress in a timely manner. Additionally, the audit identified that DoD Components did not consistently take appropriate

<sup>3</sup> OIG DoD Audit Report No. D-2005-0003, “DoD Antideficiency Act Reporting and Disciplinary Process,” October 14, 2004

Attachment

disciplinary action against personnel responsible for violations of the Antideficiency Act. Our review of Antideficiency Act investigations closed in FY 2004 showed that delays continue; however, DoD is taking aggressive action to significantly reduce the time to investigate and report violations.

**Prompt Payment Act.** The Prompt Payment Act requires DoD to maintain an internal control environment in accordance with OMB Circular A-123 “Management Accountability and Control.” In prior audit reports, we identified outstanding deficiencies in the DoD internal control environment as it relates to payments. Specifically, deficiencies related to access and accountability for resources, recording, and documentation have not been corrected.

#### **Audit Disclosures**

We did not perform audit work related to the following selected provisions of laws and regulations: Government Performance and Results Act, Debt Collection Improvement Act, Federal Credit Reform Act, and the Pay and Allowance System for Civilian Employees.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.

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