Independent Auditors' Report on the Principal Statements

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

November 12, 2006

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

SUBJECT: Independent Auditor's Report on the Fiscal Year 2006 Department of Defense Agency-Wide Financial Statements (Report No. D-2007-020)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2006 and 2005, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Consolidated 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 DoD Fiscal Year 2006 financial statements 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 the FY 2006 DoD Agency-Wide Financial Statements would not substantially conform to generally accepted accounting principles, and DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2006. 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 Department of Defense Inspector General 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 long-standing material weaknesses listed in the Summary of Internal Control. These pervasive material weaknesses also affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the basic financial statements.[1] Therefore, we are unable to express, and we do not express, an opinion on the basic financial statements. Additionally, the purpose of the audit was not to express an opinion on the information accompanying the basic financial statements. Accordingly, we express no opinion on the accompanying information.

---

[1] The annual financial statements include the basic financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other 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, 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
- Government-Furnished Material and Contractor-Acquired Material
- Environmental Liabilities
- Intragovernmental Eliminations
- Accounting Entries
- Statement of Net Cost
- Statement of Financing

We identified the following additional material weakness in FY 2006:

- Accounts Payable

Material weaknesses are reportable conditions in which internal controls do not reduce (to a relatively low level) the risk of misstatements that are material to the financial statements and that might not be timely detected by employees while performing their normal assigned functions.

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.

Our internal control work (conducted during prior audits) would not necessarily disclose all reportable conditions. The Attachment offers additional details on reportable conditions, most of which we consider to be material internal control weaknesses.

Additionally, DoD provided a qualified statement of assurance for the internal controls over financial reporting in the FY 2006 PAR. We consider the qualified statement of assurance for the internal controls over financial reporting to be misleading because the qualified statement of assurance does not accurately reflect the results of the assessments that DoD conducted in order to meet the requirements of Office of Management and Budget (OMB) Circular No. A-123, "Revisions to OMB Circular A-123, Management's Responsibility for Internal Control," December 21, 2004, Appendix A. Based on (1) the material internal control weaknesses that continue to exist; (2) management's acknowledgement that DoD's financial statements do not conform to generally accepted accounting principles; and (3) the continued existence of DoD's financial management system deficiencies, a statement of no assurance that the internal controls over financial reporting were operating effectively would be more appropriate. The statement of no assurance on the internal controls over financial reporting would reflect more clearly the level of assurance that management can provide considering the pervasive material weaknesses that affect the reliability of the DoD financial statements.

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 substantially comply 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. Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. See the Attachment for additional details on compliance with laws and regulations.

Management's Responsibilities

Management is responsible for:

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

4

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. DoD officials expressed their continuing commitment to address the problems this report outlines.

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

Attachment:
As stated

Report on Internal Control and Compliance with Laws and Regulations

Internal Control

Management is responsible for implementing and maintaining effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly; the requirements of applicable laws and regulations are met; and 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, we have identified the following material weaknesses and reportable conditions that could adversely affect a favorable opinion on internal control.

Material Weaknesses. Management acknowledged that previously identified reportable conditions, all of which are material, continue to exist.

Financial Management Systems. Statement of Federal Financial Accounting Concepts No. 1, "Objectives of Federal Financial Reporting," requires financial management system 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. Statement of Federal Financial Accounting Concepts No. 1 also requires that financial management system controls ensure 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 DoD financial management and feeder systems do not substantially comply with Federal financial management system 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.

In addition, reviews of five DoD financial management systems and Defense Information Systems Agency Computing Services identified several common vulnerabilities. Controls over security planning, access controls, and software controls did not comply with DoD information assurance requirements. As a result, potential system and procedural vulnerabilities threatened the confidentiality, integrity, and availability of financial data.

Fund Balance With Treasury. The U.S. Treasury Financial Manual and DoD Financial Management Regulation 7000.14-R require DoD 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. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," requires DoD to use historical cost, the latest acquisition cost (adjusted for holding gains and losses), or moving average cost for valuing inventory. However, DoD acknowledged that the existing inventory value for most activities is not reported in accordance with generally accepted accounting principles and the Department's legacy systems do not maintain the historical cost data necessary to comply with Statement of Federal Financial

Attachment

Accounting Standards No. 3. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by Statement of Federal Financial Accounting Standards No. 3.

Operating Materials and Supplies. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," 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 consumed.

General Property, Plant, and Equipment. Statement of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," requires DoD to record General Property, Plant, and Equipment at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, the cost and depreciation of the DoD General Property, Plant, and Equipment is not reliably reported due to: (1) an accounting requirement that classified military equipment as General Property, Plant, and Equipment (such costs were previously expensed); (2) a lack of supporting documentation for General Property, Plant, and Equipment, which were purchased many years ago; and (3) most legacy property and logistics systems that are not integrated with acquisition and financial systems and were not designed to capture the acquisition cost and the cost of modifications and upgrades, or to calculate depreciation. DoD has acknowledged that it does not currently meet Federal Accounting Standards for the financial reporting of personal property, and documentation for personal property is neither accurate nor reliable. In addition, DoD does not have adequate internal controls in place to provide reasonable assurance that real property assets are identified and properly reported in its financial reports. DoD has also acknowledged that its inability to accurately report the value of military equipment supports the probability that the financial statements are materially misstated.

Government-Furnished Material and Contractor-Acquired Material. Statement of Federal Financial Accounting Standards 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 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 its internal controls for reporting environmental liabilities do not provide reasonable assurance that cleanup costs for all of its ongoing, inactive, closed, and disposal operations are identified, consistently estimated, and appropriately reported. In addition, guidance and audit trails for estimating environmental liabilities are insufficient, and the inventory of ranges and operational activities is incomplete. DoD has also acknowledged uncertainty regarding the accounting estimates used to calculate the reported Environmental Liabilities.

Intragovernmental Eliminations. DoD disclosed that it cannot accurately identify most of its intragovernmental transactions by customer because the Department's systems do not track buyer and seller data needed to match related transactions. In addition, the Department is unable to fully reconcile intragovernmental transactions with all Federal partners. DoD acknowledged that its inability to reconcile most intragovernmental transactions results in adjustments that cannot be fully supported. For example, Defense Finance and Accounting Service Indianapolis Operations made $32.1 billion in unsupported adjustments to intragovernmental accounts to force the accounts to agree with the records of Army's trading partners.

Attachment

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, Defense Finance and Accounting Service Indianapolis recorded $270.1 billion in unsupported accounting entries to prepare the FY 2006 Army General Fund Financial Statements.

Statement of Net Cost. Statement of Federal Financial Accounting Standards Concepts 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 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.
- The Statement of Net Cost is not presented by programs that align with major goals and outputs described in the DoD's strategic and performance plans required by the Government Performance and Results Act.
- Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.

Statement of Financing. Statement of Federal Financial Accounting Standards 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 unsupported adjustments. Specifically, budgetary data do not agree with proprietary expenses and capitalized assets. DoD disclosed in Note 21 that to bring the Statement of Financing into balance with the Statement of Net Cost, an adjustment of $11.3 billion (absolute value) was made.

Accounts Payable. Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," states, "a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future." DoD acknowledged that it does not meet accounting standards for the financial reporting of public accounts payable because of its inability to support balances due to a lack of standard procedures for recording, reporting, and reconciling the amounts between the financial, accounting, and reporting systems. DoD also acknowledged Accounts Payable as a systemic weakness in its FY 2006 Annual Statement of Assurance. Additionally, the Independent Auditor's Report on five DoD Components, namely, Army General and Working Capital Funds, Navy General and Working Capital Funds, and the U.S. Army Corps of Engineers, Civil Works, each identified Accounts Payable as a material weakness. These Components comprised over 50 percent of the DoD-Wide combined reported Accounts Payable balance as of September 30, 2006.

Attachment

Other Reportable Conditions. During FY 2006, we noted deficiencies related to Accounts Receivable and Contingent Legal Liabilities.

Accounts Receivable. Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," states, "A receivable should be recognized when a Federal entity establishes a claim to cash or other assets against other entities, either based on legal provisions,…or goods and services provided." DoD has acknowledged weaknesses in Accounts Receivable because its policy is not always followed when recording, reporting, collecting, and reconciling accounts receivable. Also, our reports on Internal Control for the FY 2006 Navy General Fund, Navy Working Capital Fund, Army General Fund, and the U.S. Army Corps of Engineers, Civil Works, showed deficiencies such as inadequate audit trails and reconciliations with subsidiary records, and a general lack of controls to ensure that Accounts Receivable balances are supportable at the transaction level.

Contingent Legal Liabilities. Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended by Statement of Federal Financial Accounting Standards No. 12, requires contingent legal liabilities to be disclosed if there is at least a reasonable possibility that a loss may be incurred. We noted that significant weakness continued to exist relating to the DoD process for reporting contingent legal liabilities. For example:

- DoD excluded from its legal representation letters at least 55 pending cases with a total claim amount of $2.4 billion that individually did not exceed the DoD Agency-Wide individual reporting threshold, but in aggregate exceeded this threshold.
- Note 16 to the financial statements stated that there was a remote probability of an adverse decision against DoD for 65 legal actions, totaling approximately $484 billion. We were unable to corroborate this statement; however, we noted that the legal representation letters from the DoD Office of General Counsel showed that DoD General Counsel was unable to express an opinion on the likely outcome of 55 of the 65 pending legal actions, totaling $357 billion.

These financial management deficiencies are indications of material weaknesses and reportable conditions 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 may also contain misstatements resulting from these deficiencies.

Attachment

Compliance with Laws and Regulations

Management is responsible for complying 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 continue 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.

Federal Financial Management Improvement Act of 1996. The Federal Financial Management Improvement Act of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The Federal Financial Management Improvement Act also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management system requirements. The remediation plan is to include remedies, resources, and milestones. For FY 2006, DoD did not fully comply with the Federal Financial Management Improvement Act. DoD acknowledged that many of its critical financial management and feeder systems did not substantially comply with Federal financial management system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2006.

Government Performance and Results Act. Congress enacted the Government Performance and Results Act of 1993 (The Act) to establish strategic planning and performance measurement in the Federal Government Strategic plans, annual performance plans, and annual program performance reports comprise the main elements of The Act. DoD did not fully comply with the requirements of the Government Performance and Results Act and subsequent implementation guidance in Office of Management and Budget Circular A-11, "Preparation Submission and Execution of the Budget." Specifically, DoD did not have a compliant strategic plan for FY 2006 because DoD designated the Quadrennial Defense Review report, which was prepared to fulfill the specific legislative requirements for a Quadrennial Defense Review as its strategic plan without considering other requirements specified in The Act. As a result, the DoD performance budget and performance report for FY 2006 did not comply with the requirements of the Government Performance and Results Act and Office of Management and Budget Circular A-11.

Antideficiency Act. Section 1341, title 31, United States Code limits DoD, and its agents, to only make or authorize expenditures or obligations that do not exceed the amount available in the appropriations or funds for the expenditures or obligations. Additionally, DoD and its agents, may not contract or obligate for the payment of money before an appropriation is made available for that contract or obligation unless otherwise authorized by law. Section 1341, title 31, United States Code states if an officer or employee of an executive agency violates the Antideficiency Act, the head of the agency must report immediately to the President and Congress all relevant facts and a statement of the actions taken. During FY 2006, DoD reported nine cases where actual violations of the Antideficiency Act occurred. Therefore, DoD did not comply with section 1341, title 31, United States Code.

DoD internal guidance limits the time from identification to reporting violations of the Antideficiency Act to 12 months. Our review of DoD Antideficiency Act investigations of potential violations shows that DoD did not process Antideficiency Act violation cases within the 12-month time limit.

Attachment

Officials and employees of the Federal Government who violate the Antideficiency Act are subject to disciplinary action. DoD Financial Management Regulation 7000.14-R defines such disciplinary action to include written admonishment or reprimand, reduction in grade, suspension from duty without pay, or removal from office. However, our review of the statements of disciplinary officers for those disciplined for violating the Antideficiency Act identified that the disciplinary action was not always consistent with the DoD Financial Management Regulation.

Prompt Payment Act. The Prompt Payment Act requires the payment date for an invoice to be the date payment is due under the contract or 30 days after a proper invoice is received if a specific payment date is not established by the contract. The Prompt Payment Act also states that an agency must make payments no more than 7 days prior to the payment due date unless the agency head or designee has determined (on a case-by-case basis) that earlier payment is necessary. However, Defense Financial Accounting Service Columbus records showed that most of the interim payments on cost-reimbursement service contracts disbursed in FY 2005 through the Mechanization of Contract Service system were paid earlier than 7 days prior to the due date the system calculated.

Specifically, Defense Financial Accounting Service Columbus disbursed approximately $28.4 billion, representing 90 percent of the invoices and 88 percent of the disbursements, in interim payments on cost-reimbursement service contracts earlier than permitted by the Prompt Payment Act. Defense Financial Accounting Service Columbus paid these invoices early because it implemented Federal and DoD policies that conflicted with the Prompt Payment Act and contributed to a calculated $9.4 million in lost Federal interest based on the Treasury Current Value of Funds rate.

Improper Payments Information Act. DoD does not fully comply with the requirements of the Improper Payments Information Act of 2002, Public Law 107-300, and subsequent Office of Management and Budget guidance. Although it reported $22.5 million in improper payments related to the procurement of fuel in FY 2005, the Defense Finance and Accounting Service Columbus and the Defense Energy Support Center did not have adequate control processes in place to provide reasonable assurance that the amount reported was accurate. Furthermore, the Government Accountability Office believes that programs related to military pay, travel, property, contract payments, and automated systems may be at risk of making significant improper payments. Although DoD recently received a score of "yellow," signaling mixed results for implementing improper payments on the President's Management Agenda, DoD has taken steps to resolve some previously identified issues regarding the methodologies and processes used in reporting improper payments. Through coordination with the DoD Office of Inspector General, DoD has recently issued a policy establishing a Project Officer for Improper Payments and Recovery Auditing to review DoD's statistical methodologies and processes, and to verify DoD reporting information is accurate, complete, and meets or exceeds Office of Management and Budget minimum reporting requirements. Finally, the Project Officer will also establish an ongoing Improper Payments and Recovery Auditing working group to help DoD modify improper payment methodologies and processes as needed.

Audit Disclosures

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us on June 30, 2006, that the DoD financial management and feeder systems cannot provide adequate evidence supporting various material amounts on the financial statements. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did not perform audit work related to the following selected provisions of laws and regulations: Provisions Governing Claims of the United States Government (including provisions of the 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, or audit projects currently in process will include appropriate recommendations.

Attachment