INDEPENDENT AUDITOR'S REPORT

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

November 12, 2008

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2008 and FY 2007 Basic Financial Statements (Report No. D-2009-021)

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, 2008 and 2007, and the Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, and related notes 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 express an opinion on the DoD Agency-Wide FY 2008 and FY 2007 Basic 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 our work.

Disclaimer of Opinion on the Financial Statements

The Acting Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer acknowledged to us that the DoD Agency-Wide FY 2008 and FY 2007 Financial Statements would not substantially conform to accounting principles generally accepted in the United States of America (GAAP), and that DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2008. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to performing only those audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. Accordingly, we did not perform auditing procedures required by U.S. Government auditing standards and Office of Management and Budget (OMB) Bulletin 07-04, "Audit Requirements for Federal Financial Statements," as amended,[1] to determine whether material amounts on the financial statements were fairly presented. Prior audits have identified, and DoD has also acknowledged, the long-standing material internal control weaknesses

[1] OMB Memorandum M-08-24, Technical Amendments to OMB Bulletin 07-04, "Audit Requirements for Federal Financial Statements," August 25, 2008.

identified in the Summary of Internal Control. These pervasive material weaknesses may 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.[2] 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 Management's Discussion and Analysis, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information presented with the basic financial statements. Accordingly, we express no opinion on that information.

As discussed in Notes 6 and 25 to the basic financial statements, DoD restated the FY 2007 balance in Non-Federal Other Assets by $1.3 billion. DoD had incorrectly reported contract financing payments as expenses rather than assets in its FY 2007 financial statements because of legacy system deficiencies. This error affected the following accounts: Other Assets, Expenses, Unexpended Appropriations, Cumulative Results of Operations, and Net Position. These accounts affected various amounts reported on the following financial statements: Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position.

As discussed in Notes 20 and 25 to the basic financial statements, on September 30, 2007, DoD incorrectly reported disbursements of $1.3 billion in military pay that were actually paid on October 1, 2007. This resulted in an overstatement of FY 2007 outlays and an understatement of FY 2008 outlays. This error affected the following accounts: Delivered Orders-Obligations Paid, Delivered Orders-Obligations Unpaid, Accounts Payable, and Fund Balance with Treasury. These accounts affected various amounts reported on the Balance Sheet and the Statement of Budgetary Resources.

As discussed in Note 25, DoD changed its financial report presentation to separately report the Executive Office of the President activity not resulting from allocation transfers. The FY 2007 DoD financial statements included certain programs of the Executive Office of the President. However, revised guidance from OMB declared that these programs should be reported separately from the DoD financial statements. In addition, based on the OMB Circular A-136, "Financial Reporting Requirements," it was determined that only Executive Office of the President activity resulting from allocation transfers should be reported on the DoD financial statements. This change in reporting affected the following accounts: Total Assets ($36.8 billion), Total Liabilities ($33.2 billion), Net Cost of Operations ($19.7 billion), Net Position ($3.6 billion), and Total Budgetary Resources ($53.1 billion). These accounts affected various amounts reported on the following financial statements: Balance Sheet, Statement of Net Cost, Statement of Net Position, and Statement of Budgetary Resources.

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[2] The annual financial statements include the basic financial statements, Management's Discussion and Analysis, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

Summary of Internal Control

In planning our work, we considered DoD internal control over financial reporting and compliance with applicable laws and regulations. We did this to determine our procedures for auditing the financial statements and to comply with OMB 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 with applicable laws and regulations. However, previously identified significant deficiencies, all of which are material, continued to exist in the following areas:

- **Financial Management Systems**
- **Fund Balance with Treasury**
- **Accounts Receivable**
- **Inventory**
- **Operating Materials and Supplies**
- **General Property, Plant, and Equipment**
- **Government-Furnished Material and Contractor-Acquired Material**
- **Accounts Payable**
- **Environmental Liabilities**
- **Statement of Net Cost**
- **Intragovernmental Eliminations**
- **Other Accounting Entries**
- **Reconciliation of Net Cost of Operations to Budget**

We did not identify any additional material weaknesses for FY 2008.

A material weakness is a significant deficiency, or a combination of significant deficiencies, resulting in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.[3]

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[3] The term "remote" is defined as when the chance of a future event or events occurring is slight. Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

A significant deficiency is a control deficiency, or a combination of control deficiencies, adversely affecting the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP. Significant deficiencies result in more than a remote likelihood that a misstatement of an entity's financial statements that is more than inconsequential will not be prevented or detected. The following significant deficiency continued to exist:

- **Contingent Legal Liabilities**

Internal control work that we conducted as part of our prior audits would not necessarily disclose all significant deficiencies. The Attachment offers additional details on significant deficiencies, most of which we consider to be material internal control weaknesses.

DoD reported all of the above weaknesses in its 2008 Statement of Assurance.

Summary of Compliance with Laws and Regulations

We limited our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting because management acknowledged that instances of noncompliance identified in prior audits continued to exist. The Acting Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer acknowledged to us that DoD financial management systems do not substantially comply with Federal financial management system requirements, GAAP, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether DoD complied 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 GAAP;
- establishing, maintaining, and assessing internal control 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.

We provided a draft of this report to the Acting Under Secretary of Defense (Comptroller)/DoD 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.

Patricia A. Marsh

Patricia A. Marsh, CPA
Assistant Inspector General
Defense Business Operations

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; that the requirements of applicable laws and regulations are met; 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, we have identified the following material weaknesses and significant deficiencies that could adversely affect the DoD financial management operations.

Previously Identified Material Weaknesses. Management acknowledged that previously identified significant deficiencies, all of which are material, continued to exist in the following areas.

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: comply 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 financial management system controls to ensure that assets are properly safeguarded to deter fraud, waste, and abuse; and that performance measurement information is adequately supported. The Acting Under Secretary of Defense (Comptroller)/ DoD 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 deficiencies in financial management and feeder systems, as well as inadequate DoD business processes, prevent the DoD from collecting and reporting financial and performance information that is accurate, reliable, and timely.

Fund Balance with Treasury. Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities;" the U.S. Treasury 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. For example, the Air Force General Fund does not receive transaction-level data from other Components processing collection and disbursement data on its behalf. Therefore, there is no assurance that the Air Force can reconcile its reported balance of Fund Balance with Treasury to the balance the Treasury maintains.

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Accounts Receivable. According to Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," a receivable should be recognized when a Federal entity establishes a claim to cash or other assets against other entities, based on either legal provisions, or goods or services provided. DoD acknowledged that it is unable to accurately record, report, collect, and reconcile Intragovernmental Accounts Receivable, as well as accounts receivable due from the public. DoD identified Accounts Receivable as a material weakness based on its FY 2008 assessment of internal control over financial reporting, as required by OMB Circular A-123, Appendix A. Also, our Independent Auditor's reports on internal control for the FY 2008 Navy General and Working Capital Funds, Army General Fund, and the U.S. Army Corps of Engineers, Civil Works, revealed Accounts Receivable to be a material weakness. These Components' accounts represented approximately 58 percent of the DoD Agency-Wide combined Accounts Receivable balance as of September 30, 2008.

Inventory. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," requires DoD to use the historical cost, the latest acquisition cost (adjusted for holding gains and losses), or the moving average cost for valuing inventory. However, DoD acknowledged that the existing inventory value for most activities is not reported in accordance with GAAP, and the Department's legacy systems do not maintain the historical cost data necessary to comply with Statement of Federal Financial Accounting Standards No. 3. Also, 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. In addition, DoD cannot accurately report the value of operating materials and supplies, which causes the potential for a misstatement in financial reporting.

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 are not reliably reported because of: (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 aged General Property, Plant, and Equipment items; and (3) a failure to integrate most legacy property and logistics systems with acquisition and financial systems. Also, DoD property and logistics systems were not designed to capture acquisition cost and the cost of modifications and upgrades, or to calculate depreciation. DoD has acknowledged that it does not currently meet GAAP for the financial reporting of personal property and that 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 increases the risk 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. Such 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 these requirements for Government-Furnished Material and Contractor-Acquired Material. As a result, the value of DoD property and material in the possession of contractors is not reliably reported.

Accounts Payable. According to Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," 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. DoD cannot support its Accounts Payable balances because it lacks standard procedures for recording, reporting, and reconciling the amounts among the financial, accounting, and reporting systems. DoD identified Accounts Payable as a material weakness based on its FY 2008 assessment of internal control over financial reporting, as required by OMB Circular A-123, Appendix A. Additionally, our Independent Auditor's reports on Internal Control for the FY 2008 Army General and Working Capital Funds; Navy General and Working Capital Funds; and the U.S. Army Corps of Engineers, Civil Works, identified Accounts Payable as a material weakness. These Components represented more than 55 percent of the DoD Agency-Wide combined Accounts Payable balance as of September 30, 2008.

Environmental Liabilities. DoD has acknowledged that its internal control for reporting environmental liabilities does not provide reasonable assurance that clean-up 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.

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 explanation 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 organizations. DoD acknowledged the following deficiencies related to the Statement of Net Cost.

- The amounts presented for the General Funds may not report actual accrued costs.
- Although Working Capital Funds are generally recorded on an accrual basis, as required by GAAP, the systems do not always capture actual costs in a timely manner.

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- The Statement of Net Cost is not presented by program, in alignment with major goals and outputs described in DoD strategic and performance plans, as required by the Government Performance and Results Act.

- Revenues and expenses are reported by appropriation category because financial processes and systems do not collect costs according to performance measures.

Intragovernmental Eliminations. DoD disclosed that it cannot accurately identify most of its intragovernmental transactions by customer because DoD systems do not track the 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.

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, Defense Finance and Accounting Service (DFAS), Indianapolis Operations recorded \$595.8 billion in unsupported accounting entries to prepare the FY 2008 Army General Fund Financial Statements.

Reconciliation of Net Cost of Operations to Budget. Statement of Federal Financial Accounting Standards No. 7, "Accounting for Revenue and Other Financing Sources," requires a reconciliation of proprietary and budgetary information to assist users in understanding the relationship between the net cost of operations and the budgetary resources obligated by the entity during the period. 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 made unsupported adjustments of \$7 billion (absolute value) to reconcile obligations to the Statement of Net Cost.

Previously Identified Significant Deficiencies. As part of our financial-related audits, we noted the following significant deficiency, which continued to exist.

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, "Recognition of Contingent Liabilities Arising from Litigation," 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 deficiencies continued to exist regarding the DoD process for reporting contingent legal liabilities. Specific examples include the following.

- DoD excluded from its legal representation letters at least 94 pending cases, with a total claim amount of \$4.3 billion, that individually did not meet the DoD Agency-Wide reporting threshold but in the aggregate exceeded this threshold.

- 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 45 (totaling \$2.6 trillion) of 55 pending legal actions.

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These financial management deficiencies may cause inaccurate management information. As a result, DoD management decisions based in whole or in part on this information may be adversely affected. Financial information reported by DoD may also contain misstatements resulting from these deficiencies.

Compliance with Laws and Regulations

Management is responsible for complying with existing laws and regulations related to financial reporting. We limited our work to determine compliance with selected provisions of the applicable laws and regulations 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 overall 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 systems 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 systems requirements. The remediation plan is to include remedies, resources required, and milestones. For FY 2008, DoD did not fully comply with the Federal Financial Management Improvement Act of 1996. DoD acknowledged that many of its critical financial management and feeder systems did not substantially comply 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, 2008.

Government Performance and Results Act. Congress enacted the Government Performance and Results Act of 1993 (GPRA) to establish strategic planning and performance measurement in the Federal Government. Strategic plans, annual performance plans, and annual program performance reports represent the main elements of GPRA. DoD did not fully comply with the requirements of GPRA and subsequent implementation guidance in OMB Circular A-11, "Preparation, Submission, and Execution of the Budget." Specifically, DoD did not have a compliant strategic plan for FY 2008 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 consideration of other requirements specified in GPRA. As a result, the DoD budget and performance report for FY 2008 did not comply with the requirements of GPRA and OMB Circular A-11.

Antideficiency Act. Section 1341, title 31, United States Code (31 U.S.C. 1341) limits DoD and its agents to making or authorizing only expenditures or obligations that do not exceed the available appropriations or funds. Additionally, DoD or 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. According to 31 U.S.C. 1351, if an officer or

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employee of an executive agency violates the Antideficiency Act (ADA), the head of the agency must report immediately to the President and Congress all relevant facts and a statement of actions taken. During FY 2008, DoD reported 14 cases of violation of the ADA. Therefore, DoD did not comply with the ADA, 31 U.S.C. 1341, and 31 U.S.C. 1351.

DoD internal guidance limits the time from the start of the investigation to reporting of ADA violations to 12 months. Our review of DoD ADA investigations of potential violations shows that DoD did not process the 14 ADA violation cases within 12 months.

Prompt Payment Act. According to the Prompt Payment Act (PPA), the payment date for an invoice is 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 PPA also states that an agency must make payments no earlier 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. The PPA also requires DoD to maintain an internal control environment in accordance with OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004. In prior audit reports, we identified internal control weaknesses within the DFAS Columbus Mechanization of Contract Administration Service (contractor payment system) that resulted in incorrect payments of interest to contractors. If controls governing compliance with PPA are not corrected, DFAS Columbus could continue to pay a significant number of interest payments incorrectly and violate the provisions of the PPA.

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 OMB guidance. Specifically, DoD was still in the process of developing procedures to implement OMB's August 2006 guidance that requires additional documentation related to the identification of improper payments. The new OMB guidance requires that when an agency is unable to discern whether a payment is proper because of insufficient documentation, the payment must be considered an error. In addition, DoD efforts to manage recovery audit contracts have been largely unsuccessful. The DoD needs to disseminate existing guidance to improve contracting for recovery audits and adhere to that guidance in reporting recovered funds.

In November 2006, to facilitate DoD compliance with OMB guidance, the Office of the Acting Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer established a DoD Project Officer for Improper Payments and Recovery Auditing. The Project Officer reviews DoD statistical methodologies and processes to verify that its reporting is accurate, complete, and meets or exceeds OMB requirements. In May 2007, DoD held its first Defense Improper Payments Information Act Conference to facilitate identifying and reporting improper payments in the Department.

Audit Disclosures

The Acting Under Secretary of Defense (Comptroller)/DoD Chief Financial Officer acknowledged to us on April 7, 2008, that the DoD financial management and feeder systems cannot provide adequate evidence supporting various material amounts on the financial

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statements, and previously identified material weaknesses continue to exist. 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: the Federal Credit Reform Act of 1990, the Pay and Allowance System for Civilian Employees, and the Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act of 1996).

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance with laws and regulations, because previous audit reports contained recommendations for corrective actions or because audit projects currently in progress will include appropriate recommendations.