

UNITED STATES AIR FORCE

ANNUAL FINANCIAL STATEMENT

WORKING CAPITAL FUNDS

FISCAL YEAR 1999

AUDIT OPINION



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

FEB 14 2000

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND
CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Endorsement of the Disclaimer of Opinion on the FY 1999 Air Force Working Capital Fund Financial Statements (Project No. OFD-2112)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General. We delegated to the Air Force Audit Agency (AFAA) the audit of the FY 1999 Air Force Working Capital Fund financial statements. Summarized as follows are the AFAA disclaimer of opinion on the FY 1999 Air Force Working Capital Fund financial statements and the results of our review of the AFAA audit. The information provided in this memorandum contains reasons for the AFAA disclaimer. We endorse the disclaimer of opinion expressed by AFAA.

Disclaimer of Opinion. The AFAA disclaimer of opinion on the FY 1999 Air Force Working Capital Fund financial statements, dated February 9, 2000, states that AFAA was unable to express an opinion on the financial statements. We concur with the AFAA disclaimer of opinion. The AFAA disclaimer of opinion concludes that financial information was unreliable and financial systems and processes, as well as associated internal control structures, were inadequate to produce reliable financial information, as indicated in the following examples:

- System limitations precluded the Air Force from providing sufficient audit trails to confirm the value and the in-transit inventory reported as part of inventory held for sale on the balance sheet statement.
- Air Force depot maintenance systems lacked a single transaction-driven general ledger for reliable financial reporting, did not follow the percentage-of-completion method of accounting, and continued to account for cost of goods sold and work-in-process at estimated amounts instead of at actual cost.
- The value of Air Force property, plant, and equipment reported on the financial statements continued to be unauditable.
- At the time of the audit, Air Force Depot Maintenance Activity Group accounting systems did not retain subsidiary ledgers and special journals created during the processing of accounting transactions.

Internal Controls. The AFAA determined that internal controls did not provide reasonable assurance that the FY 1999 Air Force Working Capital Fund financial statements contained no material misstatements. For example, the Air Force was unable to provide supporting documentation for \$1.08 million in adjustments to the real property financial records, for \$85.4 million in disbursement transactions, for sales transactions valued at

\$64.6 million, and for \$211.5 million in open obligations. Additionally, the Defense Finance and Accounting Service made \$14.2 billion in unsupported monthly adjustments and \$65.1 billion in unsupported year-end adjustments to the Air Force Working Capital Fund accounting records. The Air Force and the Defense Finance and Accounting Service recognized many of the financial reporting weaknesses and reported them in their FY 1999 Annual Statements of Assurance.

Compliance With Laws and Regulations. AFAA identified areas of noncompliance with laws and regulations. Under the Federal Financial Management Improvement Act of 1996, AFAA work showed that the financial management systems did not substantially comply with Federal financial management system requirements, applicable Federal financial accounting standards, and the U.S. Government Standard General Ledger at the transaction level. Details on the adequacy of internal controls and on compliance with laws and regulations are discussed in the AFAA report.

Review of Air Force Audit Agency Work. To fulfill our responsibilities for determining the accuracy and completeness of the independent work that AFAA conducted, we reviewed the audit approach and planning and monitored progress at key points. We also performed other procedures to determine the fairness and accuracy of the approach and conclusions.

We reviewed the AFAA work on the FY 1999 Air Force Working Capital Fund financial statements from October 27, 1999, through February 9, 2000, in accordance with generally accepted Government auditing standards. We found no indication that we could not rely on the AFAA disclaimer of opinion or its related evaluation of internal controls and compliance with laws and regulations.



David K. Steensma
Deputy Assistant Inspector General
for Auditing



DEPARTMENT OF THE AIR FORCE
WASHINGTON DC 20330-1000

OFFICE OF THE SECRETARY

9 February 2000

To the Secretary of the Air Force
Chief of Staff, USAF

We were engaged to audit the Air Force Working Capital Fund financial statements for the fiscal year ended 30 September 1999. The annual financial statements consist of the Balance Sheet and the related Statement of Net Cost, Statement of Change in Net Position, Statement of Budgetary Resources, and Statement of Financing. Preparation of these financial statements is the responsibility of the Defense Finance and Accounting Service (DFAS) and Air Force management. This report presents our independent opinion on the financial statements, evaluation of the effectiveness of internal controls over financial reporting, and assessment of compliance with laws and regulations.

OPINION ON THE FINANCIAL STATEMENTS

We were not able to obtain sufficient evidential matter, or to apply other auditing procedures, to satisfy ourselves as to the fairness of the Air Force Working Capital Fund financial statements. Amounts reported in the consolidated financial statements and related notes may not provide a reliable source of information for decision making by the government or the public. Therefore, in accordance with *Government Auditing Standards* and the provisions of Office of Management and Budget (OMB) Bulletin, Audit Requirements for Federal Financial Statements, 22 July 1999, we are unable to express, and we do not express, an opinion on the reliability of the Air Force Working Capital Fund financial statements for the fiscal year ended 30 September 1999.

We base this disclaimer on the inability of the Air Force and DFAS to correct previously reported material deficiencies affecting the reliability of the Air Force Working Capital Fund financial statements. Both the Air Force and DFAS are continuing their efforts to improve financial reporting; however, financial systems and processes, as well as associated internal control structures, remain inadequate to produce reliable financial information. For example:

- Systems limitations precluded the Air Force from providing sufficient audit trails to confirm and value the in-transit inventory reported as part of inventory held for sale on the balance sheet statement.

- Air Force depot maintenance systems still require transition to a single transaction-driven general ledger, the percentage-of-completion method of accounting, and cost of goods sold and work-in-process reporting at actual rather than estimated amounts.
- The value of Air Force property, plant, and equipment (PP&E) reported on the financial statements continued to be unverifiable.
- Air Force Depot Maintenance Activity Group (DMAG) current accounting systems did not retain subsidiary ledgers and special journals created during the transaction accounting process.

These deficiencies materially affected information in the Air Force Working Capital Fund Fiscal Year (FY) 1999 financial statements.

REQUIRED SUPPLEMENTARY INFORMATION

The Required Supplementary Information for Deferred Maintenance is not a mandatory part of the Air Force Working Capital Fund principal financial statements, and we did not audit and do not express an opinion on such information. We did not apply certain procedures prescribed by professional standards because the information reported derives from the same data sources as the financial statements and, as such, may not provide a reliable source for the information.

FINANCIAL MANAGEMENT IMPROVEMENTS UNDERWAY

The Air Force, DoD, and DFAS continue actions to improve the Air Force Working Capital Fund financial data accuracy and reporting. Examples of on-going initiatives that should contribute to this goal are discussed below.

- The Air Force continues to design and implement an integrated depot-level and base-level supply system. When implemented, the system will have the capability, through subsidiary records, to account for inventory in-transit and to capture data necessary for inventory valuation at cost. The goal is to achieve full operational capability in FY 2002 for the base-level portion of the system.
- In the depot maintenance area, the Air Force continues efforts to implement corrections needed for depot maintenance systems to become Chief Financial Officers (CFO) Act compliant. When implemented, these systems will provide an automated transaction-driven general ledger, recognize revenue using percentage-of-completion methodology, track actual cost, and provide subsidiary support for account balances. The Air Force targeted FY 2001 to implement changes to the organic depot maintenance systems and FY 2002 for implementing re-engineering efforts to the contract depot maintenance systems.

- To address the valuation of PP&E assets, DoD and the Air Force hired contractors to assist management in assessing the existence, completeness, and valuation of assets recorded in databases. These efforts began in November 1998 and continued during FY 1999.
- The DFAS has current initiatives to improve the accuracy and timeliness of financial reporting. One of these initiatives is to replace the Departmental On-Line Accounting and Reporting System with the Defense Departmental Reporting System. Anticipated benefits of the new system include the standardization of the departmental reporting process and consolidation of CFO statements from a single system. The DFAS estimates implementation for this system in January 2001.

We believe these efforts are steps in the right direction and will resolve many existing system problems. We will continue working closely with management to address the material deficiencies precluding an unqualified audit opinion.

REPORT ON THE EFFECTIVENESS OF INTERNAL CONTROLS

Management is responsible for establishing and maintaining an internal control structure to provide reasonable, but not absolute, assurance that transactions are properly recorded, processed, and summarized to permit (a) financial statement preparation in accordance with generally accepted accounting standards, and (b) safeguarding assets against loss from unauthorized acquisition, use, or disposal. Because of inherent limitations in any internal control, errors or fraud may nevertheless occur and not be detected. Also, projection of any internal control evaluation to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Under auditing standards, a material weakness is a condition in which the design or operation of the specific internal control structure element does not reduce to a relatively low level the risk that errors or irregularities, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure over financial reporting that, in our judgment, could adversely affect the Air Force's ability to record, process, summarize, and report Working Capital Fund financial data.

Although we accomplished internal control testing, our financial statement audit objectives did not include providing a separate internal control opinion; accordingly, we do not express such an opinion. However, the OMB Bulletin, Audit Requirements for Federal Financial Statements, requires that we describe reportable conditions and material weaknesses identified during the audit. Therefore, the following paragraphs summarize material weaknesses and reportable conditions that existed in the design or

operation of the internal control structure over financial reporting in effect at 30 September 1999. Based on these weaknesses, we determined the internal control structure did not provide reasonable assurance of achieving the internal control objectives described in the OMB Bulletin, Audit Requirements for Federal Financial Statements. Most material weaknesses and reportable conditions presented in this report are the same as those included in prior year reports of audit on the Air Force Working Capital Fund financial statements. These weaknesses, along with recommended remedial actions, timeframe for corrective actions, and management comments, are more fully described in separate audit reports to Air Force and DFAS management.

Material Weaknesses

- **Supporting Documentation.**

DFAS-Columbus did not provide supporting documentation for 67 (\$85.4 million) of 345 (\$399.5 million) disbursement transactions tested. (Draft Report of Audit 99068018, Air Force Working Capital Fund, Fiscal Year 1999, Collections and Disbursements)

Air Force personnel did not provide supporting documentation for 554 (\$64.6 million) of 1,000 (\$109.3 million) Supply Management Activity Group sales transactions tested. (Draft Report of Audit 99068003, Supply Management Activity Group Sales and Accounts Receivable, Fiscal Year 1999)

Air Force fund managers did not provide supporting documentation for 700 (\$211.5 million) of 2,526 (\$1.1 billion) open obligation transactions tested (such as undelivered orders outstanding, accounts payable, unfilled customer orders, and accrued expenses). (Draft Report of Audit 99068009, Budgetary Resources, Air Force Working Capital Fund, Fiscal Year 1999)

Air Force property officers did not provide supporting documentation for \$1.08 million in adjustments to the real property financial records. (Draft Report of Audit 99068002, Review of the Air Force Working Capital Fund Real Property, Fiscal Year 1999)

- **Accounting Adjustments.** The DFAS-Denver Center made \$14.2 billion in unsupported monthly adjustments and \$65.1 billion in unsupported year-end adjustments to Air Force Working Capital accounting records. (Office of the Inspector General, Department of Defense, Draft Report of Project 0FD-2112.01, untitled)
- **Account Differences.** The DFAS-Denver Center could not explain differences in disbursements and collections recorded in Air Force Working Capital Fund accounting records and those recorded in US Treasury records. In FY 1999, the net unexplained monthly differences ranged from \$497,300 to a negative

\$186,400,000 for individual activity groups of the Air Force Working Capital Fund. Therefore, the Air Force has no assurance that US Treasury disbursements and collections represent proper charges to the Air Force Working Capital Fund, or that disbursements and collections are properly recorded in the accounting records. (Office of the Inspector General, Department of Defense, Draft Report of Project OFD-2112.01, untitled)

- Accounting Systems. The accounting systems used by the Air Force Working Capital Fund have not fully implemented the United States Government Standard General Ledger (USGSGL) at the transaction level for budgetary accounts. Therefore, instead of using budgetary accounts to prepare the Report of Execution, DFAS-Denver Center must rely on proprietary and statistical accounts and data that are not recorded in the accounting records. As a result, the amounts presented in the Report of Execution are not auditable. (Office of the Inspector General, Department of Defense, Draft Report of Project OFD-2112.01, untitled)

Reportable Conditions

- Accounting Systems. Due to significant accounting system internal control weaknesses, neither DFAS nor the Air Force can ensure they properly record, process, and summarize only valid transactions and provide accurate information (Table 1). To prepare Air Force Working Capital Fund financial statements, much of the data feeding the Air Force and DFAS financial systems comes from non-financial systems, especially logistics systems. Therefore, the method for preparing financial statements is fragmented and complex due to lack of integrated, double-entry, transaction-driven general ledgers to compile and report reliable and auditable information. Normally, feeder system information is converted to financial information leaving an unauditable trail from transaction occurrence through accounting record recognition and, ultimately, to the financial statements. We believe this cumbersome compilation process could adversely affect the Air Force Working Capital Fund's internal control process, which is designed to provide reasonable assurance concerning the reliability of financial and performance reporting, as well as compliance with applicable laws and regulations.

Table 1 - APPLICATION CONTROL WEAKNESSES

APPLICATION CONTROLS	D035A	G004H	D035J	G017	H117	G004B	G037G	H103	G072A	G072D	D035K	D200
Transaction Histories	X	X	X	X	X	X	X			X		X
Audit Trails	X	X	X	X	X	X	X			X		
Electronic Interface		X		X		X	X	X	X	X		
Access Controls	X		X	X	X		X	X	X	X	X	X
Separation of Duties			X		X		X	X	X	X		
System Edits				X				X				
Query Languages	X		X					X			X	
Transaction Processing			X	X	X	X			X	X	X	
Transaction Support				X					X	X		
Error Correction		X	X	X			X		X			
Data Verification				X	X							
Data Reconciliation	X		X	X	X			X				
System Change Controls	X						X		X			
System Documentation	X		X	X		X		X	X	X	X	
Computational Accuracy			X									
Data Usefulness		X		X		X	X	X				

D035A Item Manager Wholesale/Retail Requisition System
G004H Actual Material Cost System
D035J Financial Inventory & Billing System
G017 Depot Maintenance Equipment Program
H117 Time and Attendance Reporting System
G004B Project Order Control System

G037G Maintenance Labor Distribution and Cost System
H103 Central Procurement Accounting System
G072A Depot Maintenance Production and Cost System
G072D Contract Depot Maintenance Production and Cost System
D035K Wholesale and Retail Receiving and Shipping System
D200 Requirements Data Bank

Federal Financial Management Improvement Act of 1996 Review

With respect to management's disclosure of internal control material weaknesses in the agency's Federal Managers' Financial Integrity Act (FMFIA) report, we did not identify any material weaknesses related to financial reporting not previously covered in management's FMFIA report.

Status on Prior Year's Findings

Over the last 8 years, we identified numerous findings and made recommendations to improve internal controls related to financial reporting in the Working Capital Fund. We noted progress in several areas to correct the previously identified problems. For the most part, however, significant corrective actions are still in process. Appendix I identifies the prior report findings and recommendations we determined are uncorrected for FY 1999.

Performance Measure Information

With respect to internal controls related to performance measures reported in the overview to the principal statements and notes, we did not identify any control weaknesses in our limited review. However, we only obtained an understanding of the sources and controls related to performance measures; our work was not intended to determine whether controls were in place and working as designed.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Air Force management is responsible for complying with laws and regulations applicable to the Air Force Working Capital Fund. Issues that should concern management include compliance with laws and regulations pertaining to the objectives of Air Force Working Capital Fund programs and the activities, functions, and manner in which programs and services are to be delivered. Material instances of noncompliance are failures to follow requirements or violations of prohibitions contained in laws or regulations that cause us to conclude the aggregation of the misstatements resulting from those failures or violations is material to the financial statements, or the sensitivity of the matter would cause others to perceive the misstatements as significant.

Our financial statement audit objectives did not include providing a separate opinion on overall compliance with laws and regulations, and accordingly, we do not express such an opinion.

The Secretary of the Treasury, Director of OMB, and Comptroller General of the United States established the Federal Accounting Standards Advisory Board in October 1990 to develop accounting standards to improve the usefulness of federal financial reports. Currently, these standards include 14 Statements of Federal Financial Accounting Standards (SFFAS) and three Statements on Federal Financial Accounting Concepts. During FY 1999, we determined whether Air Force and DFAS effectively implemented these standards.

Under the Federal Financial Management Improvement Act of 1996, we are required to report whether the agency's financial management systems substantially comply with the federal accounting standards, federal financial management systems requirements, and the USGSGSL at the transaction level. We address the instances of noncompliance with these requirements below. In addition, these weaknesses, along with recommended corrective actions, timeframes for corrective actions, and management comments, are described in the cited supporting reports.

- **Statements of Federal Financial Accounting Standards (SFFASs).** The financial management systems that supported the Air Force Working Capital Fund did not substantially comply with federal accounting standards. Specifically:

SFFAS No. 1, Accounting for Selected Assets and Liabilities. The DMAG recorded accrued liability and work-in-process costs based on estimated amounts instead of actual costs incurred. (Report of Audit 98068038, Contract Depot Maintenance Financial Processing, Depot Maintenance Activity Group, Air Force Working Capital Fund, Fiscal Year 1998, 12 July 1999)

SFFAS No. 3, Accounting for Inventory and Related Property. The DMAG recorded the value of operating materials and supplies at current stock list unit prices instead of historical cost. (Report of Audit 97068017, Compliance with Federal Financial Accounting Standards Numbers 1 and 3, 15 September 1998)

SFFAS No. 6, Accounting for Property, Plant, and Equipment. Air Force Working Capital Fund entities did not record all costs incurred in valuing PP&E assets. (Report of Audit 98068002, Air Force Depot Maintenance Property, Plant, and Equipment, 16 July 1999; and Report of Audit 98068038, Contract Depot Maintenance Financial Processing, Depot Maintenance Activity Group, Air Force Working Capital Fund, Fiscal Year 1998, 12 July 1999)

SFFAS No. 7, Accounting for Revenue and Other Financing. The DMAG recorded revenue based on completed units instead of the percentage-of-completion method. (Memorandum Audit Report 98068006, Depot Maintenance Activity Group, Air Force Working Capital Fund, 12 March 1999; and Report of Audit 98068038, Contract Depot Maintenance Financial Processing, Depot Maintenance Activity Group, Air Force Working Capital Fund, Fiscal Year 1998, 12 July 1999)

- **Federal Financial Management Systems Requirements.** The financial management systems that support the Air Force Working Capital Fund did not substantially comply with federal financial management system requirements to:
 - Maintain adequate subsidiary records for audit trails in Air Force and DFAS financial management systems;
 - Implement Air Force DMAG systems with general ledgers that are transaction driven; and
 - Provide adequate application controls to critical Air Force feeder systems such as separation of duties, support for transactions, transaction controls, and data reconciliation. We address these application control deficiencies more fully in Table 1, page 6 of this report.

- **USGSGL at the Transaction Level.** For FY 1999, Air Force and DFAS managers did not implement the USGSGL at the transaction level. The DFAS plans to incorporate the Standard General Ledger in the Defense Industrial Financial Management System scheduled for implementation in October 2000 at the Ogden Air Logistics Center. The Air Force also plans to implement the Standard General Ledger in the re-engineering of its contract depot maintenance systems.

The Air Force acknowledged, in its management representation letter for the FY 1999 Working Capital Fund financial statements, that Air Force financial management systems contain several departures from federal accounting standards. The Air Force is working hard to correct these problems, but will require several years to achieve substantial progress on the issues.

OBJECTIVE, SCOPE, AND METHODOLOGY

Management is responsible for:

- Preparing the annual financial statements in conformity with applicable accounting principles,
- Establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of the FMFIA are met, and
- Complying with applicable laws and regulations.

The Air Force Audit Agency (AFAA) is responsible for:

- Planning and performing an audit to obtain reasonable assurance about whether the principal financial statements are reliable (free of material misstatement) and presented fairly in conformity with OMB Bulletin 97-01, Form and Content of Agency Financial Statement, 16 October 1996, as amended 20 November 1998, and applicable accounting principles;
- Obtaining reasonable assurance about whether relevant management internal controls are in place and operating effectively; and
- Testing management's compliance with selected provisions of laws and regulations and perform limited procedures to test the consistency of other information presented in the annual financial statement with the consolidated financial statements.

To fulfill these responsibilities, we:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the principal financial statements;
- Assessed the accounting principles used and significant estimates made by management;
- Evaluated the overall presentation of the financial statements;
- Tested compliance with selected provisions of laws and regulations;
- Obtained an understanding of the internal control design, determined whether internal controls were placed in operation, assessed control risk, and performed tests of the reporting entity's internal controls; and
- Followed up on previously reported deficiencies.

In reviewing the Air Force Working Capital Fund consolidated financial statements, we evaluated internal controls to determine the reliability of financial and performance reporting related to the principal statements, accompanying footnotes, and performance measures.

In the area of financial reporting, we determined whether Air Force and DFAS personnel properly recorded, processed, and summarized transactions to permit the preparation of financial statements in accordance with federal accounting standards. We also evaluated the safeguarding of assets against loss from unauthorized acquisition, use, or disposition; obtained an understanding of the design of internal controls; determined whether they were in operation; assessed control risk; and tested controls.

In the area of performance measures, we obtained an understanding of the internal control design related to the existence and completeness assertions relevant to the performance measures included in the overview accompanying the Air Force Working Capital Fund financial statements.

We obtained audit assistance from the Inspector General, Department of Defense (DoDIG). The DoDIG Denver Field Office assisted us in reviewing the DFAS-Denver Center's compilation of the FY 1999 Air Force Working Capital Fund financial statements. We believe our audit work and the work of the DoDIG provide a reasonable basis for our audit opinion.

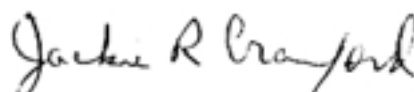
We accomplished the audit from January to December 1999 at the Office of the Secretary of the Air Force, Financial Management and Comptroller; DFAS locations (DFAS centers and DFAS operating locations); Headquarters Air Force Materiel Command; and Air Force active duty units. We listed specific locations in separate audit

reports issued to Air Force and DFAS management. We provided a draft report to management in February 2000.

SUMMARY OF PRIOR AUDIT COVERAGE

The General Accounting Office, DoDIG and the AFAA, have conducted multiple reviews related to financial management issues. We issued a disclaimer on the FY 1998 Air Force Working Capital Fund Financial Statements. The GAO reports can be accessed over the Internet at <http://www.gao.gov>; DoDIG reports can be accessed at <http://www.dodig.osd.mil>; and AFAA reports can be accessed at <http://www.afaa.af.mil>.

We appreciate the cooperation and courtesies extended to our auditors.

A handwritten signature in dark ink, reading "Jackie R Crawford". The signature is written in a cursive, flowing style.

JACKIE R. CRAWFORD
The Auditor General