Audit Report

OFFICE OF THE INSPECTOR GENERAL

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE DEFENSE BUSINESS OPERATIONS FUND CONSOLIDATED FINANCIAL STATEMENTS FOR FY 1996

Report No. 97-178 June 26, 1997

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Department of Defense

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Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
GAO	General Accounting Office
IG	Inspector General
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
PP&E	Property, Plant, and Equipment
USD(C)	Under Secretary of Defense (Comptroller)

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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June 26, 1997

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

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1996 (Report No. 97-178)

We are providing this report for your information and use. Financial statement audits are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, requires the Inspector General, DoD, to render an opinion on the financial statements and report on the adequacy of internal controls and compliance with laws and regulations. We will issue a separate report detailing the major deficiencies of the Defense Business Operations Fund and explaining the DoD progress in correcting the fundamental problems in the internal control structure.

We were unable to render an opinion on the Defense Business Operations Fund Consolidated Financial Statements because the lack of a sound internal control structure and significant deficiencies in the Fund's accounting systems prevented the preparation of accurate financial statements. Our opinion and the financial statements are included in Appendix C. Part I of this report discusses material weaknesses in internal controls and noncompliance with laws and regulations. Part II of this report contains relevant appendixes for management use.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent, Audit Program Director, at (703) 604-9110 (DSN 664-9110), or Mr. John M. Seeba, Audit Project Manager, at (703) 604-9134 (DSN 664-9134). See Appendix G for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Office of the Inspector General, DoD

Report No. 97-178 **June 26, 1997**
(Project No. 5FH-2015.01)

Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1996

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of the financial statements of the Defense Business Operations Fund. The Defense Business Operations Fund was established as a revolving fund in FY 1992 and consists of business areas such as Supply Management, Depot Maintenance, and Transportation. The Defense Business Operations Fund Consolidated Financial Statements for FY 1996 reported total assets of $92.2 billion and total revenues and financing sources of $73.7 billion.

The Defense Business Operations Fund Corporate Board and the Office of the Under Secretary of Defense (Comptroller) were responsible for oversight of the Defense Business Operations Fund, while the Military Departments and Defense agencies were responsible for the day-to-day management and operational responsibilities.

In December 1996, the Under Secretary of Defense (Comptroller) announced that the existing Defense Business Operations Fund would be eliminated and separate working capital funds would be established. Under the working capital fund concept, each of the Components will be responsible for managing the functional and financial aspects of their support functions and activities and should retain their individuality in managing operations. This restructuring does not materially affect the issues raised in this report.

Audit Objectives. The primary audit objective was to determine whether the FY 1996 Defense Business Operations Fund Consolidated Financial Statements were presented fairly in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. In addition, we determined whether controls were adequate to ensure that the consolidated financial statements were free of material error. We also assessed compliance with laws and regulations for transactions and events that have a direct and material effect on the financial statements. Additionally, we followed up on conditions noted in previous audits of the Defense Business Operations Fund financial statements.

Disclaimer of Opinion. We were unable to render an opinion on the Defense Business Operations Fund Consolidated Financial Statements as of September 30, 1996. Our opinion was included in the published financial statements transmitted by the Under Secretary of Defense (Comptroller) to the Office of Management and Budget. See Appendix C for the financial statements and auditor opinion.

Internal Controls. As reported in previous Defense Business Operations Fund reports and acknowledged in the Under Secretary of Defense (Comptroller) management representation letter, a sound internal control structure has not been established. Until a sound internal control structure is in place, material internal control weaknesses will

continue to hamper the Defense Business Operations Fund's financial systems. Material internal control weaknesses identified in previous Defense Business Operations Fund reports, such as inadequate accounting systems and lack of policy and procedures, still exist. We were unable to use other audit tests and procedures to determine whether the account balances were fairly presented. Part I.A. contains our report on internal controls.

Compliance With Laws and Regulations. Although progress has been made, noncompliance with laws and regulations continues to materially affect the reliability of the consolidated Defense Business Operations Fund financial statements. Financial statements do not accurately disclose the financial position of Defense Business Operations Fund organizations. Noncompliance with DoD 7000.14-R, "DoD Financial Management Regulation," was identified in areas such as property, plant, and equipment; accounts payable; depreciation; and revenue recognition. We could not determine the range and magnitude of noncompliance with fiscal statutes. Part I.B. contains our report on compliance with laws and regulations. Appendix D lists the laws and regulations tested.

Summary of Recommendations. The supporting Military Department audit organizations made specific recommendations. Refer to Appendix A for a listing of their reports.

Related Reports. We will issue a separate report on the major deficiencies of the Defense Business Operations Fund, highlighting DoD progress in correcting the fundamental problems in the internal control structure.

Table of Contents

Executive Summary i

Part I - Audit Results

Audit Background 2
Audit Objectives 3

Part I. A. - Review of Internal Control Structure

Introduction 6
Reportable Conditions 7

Part I. B. - Review of Compliance With Laws and Regulations

Introduction 16
Reportable Conditions 16

Part II - Additional Information

Appendix A. Audit Process
Scope 24
Methodology 28
Appendix B. Prior Coverage 30
Appendix C. Financial Statements and Auditor Opinion 41
Appendix D. Laws and Regulations Reviewed 80
Appendix E. Financial Statement Reporting Structure for the Defense Business Operations Fund 83
Appendix F. Management Representation Letter 84
Appendix G. Report Distribution 91

Part I - Audit Results

Audit Background

The Chief Financial Officers Act, as amended, requires an annual audit of financial statements for revolving funds such as the Defense Business Operations Fund (DBOF). Preparation of the financial statements is the responsibility of the Defense Finance and Accounting Service (DFAS). The DoD Components and DFAS are jointly responsible for the information in the statements. Our responsibility is to render an opinion on those statements based on our audit. Appendix A discusses scope and methodology, auditing standards, and accounting principles applicable to this audit. Appendix A also discusses the Overview to the DBOF FY 1996 financial statements and assistance from the Military Department audit organizations.

Disclaimer of Opinion. We were unable to render an opinion on the FY 1996 DBOF Consolidated Financial Statements. See Appendix C for the Financial Statements and Auditor Opinion.

Related Reports. We plan to issue a separate report focusing on the major deficiencies of the DBOF. That report will discuss the major obstacles in the development and use of DBOF financial statements. We will also highlight DoD progress in correcting fundamental problems in the DBOF internal control structure.

DBOF History. Congress created the DBOF on October 1, 1991, by combining the DoD- and Service-owned revolving funds that were previously called the stock and industrial funds. Subsequently, the DFAS, the Defense Information Systems Agency, the Defense Commissary Agency, the Defense Technical Information Center, the U.S. Transportation Command, the Joint Logistics Systems Center, and a Defense Logistics Agency (DLA) function (the Defense Reutilization and Marketing Service) were added to the DBOF. Appendix E shows the reporting structure for the DBOF.

In December 1996, the Under Secretary of Defense (Comptroller) (USD[C]) announced that the existing DBOF would be eliminated and separate working capital funds would be established. Under the working capital fund concept, each Component will be responsible for managing the functional and financial aspects of their support functions and activities and will retain their individuality in managing operations. To clearly reflect each Component's responsibility for the functions within their working capital fund, individual program and financial statements will be presented for each working capital fund, and there will be no Department-wide budget authorization for a consolidated working capital fund. To accommodate the conversion to working capital funds and to retain the benefits resulting from the actions of the DBOF Corporate Board, the Board will be rechartered as the Working Capital Funds Policy Board. This restructuring does not materially affect the issues raised in this report.

Audit Objectives

Our overall objective was to determine whether the FY 1996 DBOF Consolidated Financial Statements were presented fairly in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Additional objectives were to evaluate internal controls and compliance with applicable laws and regulations and to follow up on conditions noted in previous audits of the DBOF financial statements. Part I.A. contains our report on internal controls. Part I.B. contains our report on compliance with laws and regulations. Appendix A provides the scope and methodology, auditing standards, and accounting principles. Appendix B provides a summary of prior audit coverage.

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Part I.A. - Review of Internal Control Structure

Introduction

Audit Responsibilities. Our audit objective was to determine whether controls over transactions supporting the accounts in the FY 1996 DBOF Statement of Financial Position and the Statement of Operations were adequate to ensure that the accounts were free of material error. In planning and performing our audit of the DBOF accounts for the year ended September 30, 1996, we evaluated the internal control structure. We performed this evaluation to:

- determine the auditing procedures necessary to express an opinion on the financial statements; and

- determine whether an internal control structure had been established.

That determination included obtaining an understanding of the internal control policies and procedures, as well as assessing the level of control risk relevant to all significant cycles, classes of transactions, and account balances. For those significant control policies and procedures that had been properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For areas where internal controls were determined to be weak, we attempted to perform tests to determine the level of assurance that could be placed on those controls. The lack of an adequate internal control structure resulted in a disclaimer of opinion on the consolidated financial statements.

Management Responsibilities. DBOF management was responsible for establishing and maintaining an internal control structure. In fulfilling that responsibility, management was required to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The Office of the USD(C) and the Corporate Board set overall policy for the DBOF, and the Military Departments and Defense agencies were responsible for management and operations. We reviewed the internal control structure to render an opinion on the financial statements. An internal control structure should provide management with reasonable but not absolute assurance that:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;

- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation;

- transactions that could have a direct and material effect on the consolidating statements, including those related to obligations and costs, are executed in compliance with laws and regulations directly related to the statements and with any other laws and regulations that the OMB,

entity management, or the Inspector General (IG), DoD, have identified as being significant and for which compliance can be objectively measured and evaluated;

- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information; and

- questions are answered concerning the existence of performance measures and their adequacy.

Internal Control Structure. The three elements of the control structure are the control environment, accounting and related systems, and control procedures. The control environment is the collective effort of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management's philosophy and operating style, the entity's organizational structure, and personnel policies and practices. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of control and emphasis placed on it within the entity. Accounting and related systems are the methods and records established to identify, assemble, analyze, classify, record, and report on the entity's transactions and to maintain accountability for the related assets and liabilities. Control procedures are the policies and procedures, in addition to the control environment and accounting and related systems, that management has established to provide reasonable assurance specific objectives will be achieved.

Reportable Conditions

We attempted to examine the internal control structure of the DBOF for the year ending September 30, 1996. Our review of DBOF internal controls disclosed material internal control weaknesses as defined by DoD Directive 5010.38,* "Internal Management Control Program," April 14, 1987. We also identified conditions that we considered to be reportable under OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal control structure does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would occur to an extent that would be material to the statements being audited, or

*DoD Directive 5010.38 has been revised as "Management Control Program," August 26, 1996. The audit was performed under the April 1987 version of the directive.

material to a performance measure or aggregation of related performance measures, and would not be detected in a timely manner by employees in the normal course of performing their functions.

Overall Conditions Noted. Internal controls for the DBOF were not adequate. Material internal control weaknesses existed in each of the areas reviewed. Internal controls in areas not reviewed should not be considered adequate until tests can be performed to determine whether those controls are established and working. Because of inadequacies in the internal control structure, we could not determine whether the amounts reflected all errors; therefore, we could not determine an account balance that was fair and reasonable.

Table 1 summarizes the major internal control deficiencies and the corresponding impact (if any) on the FY 1996 DBOF Consolidated Financial Statements.

Adjusting Entries. Internal controls over adjusting journal entries at the DFAS Denver Center were not adequate. The DFAS Denver Center made 124 adjustments for Air Force, U.S. Transportation Command, and Joint Logistics Systems Center financial data totaling $227.3 billion. For 111 of those adjustments, valued at $217.5 billion, the DFAS Denver Center made adjustments without supporting documentation. In addition, adequate written explanation of why the adjustment was made was not provided for 90 of the adjustments. These conditions occurred because the DFAS Denver Center did not have adequate management controls over the processing of adjusting journal entries. In addition, DFAS had not provided adequate written guidance for preparing adjusting journal entries. A complete discussion of the deficiencies noted at the DFAS Denver Center will be presented in a future IG, DoD, audit report.

Air Force Cash Management. The Air Force did not possess adequate internal accounting controls over DBOF cash transactions. During FY 1996, cost accountants did not record $13.2 billion in collections and $13.5 billion in disbursements in the period the transactions occurred. The Air Force and other DoD disbursing officers disbursed $13.5 billion without determining the availability of cash at the U.S. Treasury, as required by public law. These conditions occurred because the DoD cash systems allowed outside entities to access Air Force DBOF cash without Air Force approval. Furthermore, the cash systems lacked a real-time capability to report transactions and determine the fund balance at Treasury.

Property, Plant, and Equipment (PP&E). We could not validate the accuracy of the $11.9 billion PP&E consolidated DBOF balance for FY 1996. This occurred because the Army and the Air Force could not produce reliable universe data for $2 billion of PP&E assets. This was a material portion of the consolidated balance that limited the scope of the audit and prevented us from assessing the accuracy of the PP&E value reported on the consolidated financial statements.

Table 1. Summary of Major Internal Control Deficiencies for the FY 1996 DBOF Consolidated Financial Statements

Issue	Impact
Adjusting Entries	113 of 123 adjusting vouchers, valued at $226 billion, were not supported or approved.
Cash Management	Air Force did not record collections of $13.2 billion and disbursements of $13.5 billion in the period the transactions occurred.
PP&E	$11.9 billion consolidated balance could not be validated. $3.6 billion of equipment-in-use was materially misstated.
Expenses	$4.7 billion of prior-year expenses were included in the current-year Cost of Goods Sold calculation.
Inventory	Purchases were overstated by $763.6 million. Inventory at Repair Contractors was overstated by $711 million.
Accounting Periods	$257.7 million was recorded in general ledger accounts during the wrong accounting periods.
Materiel Returns	$167.2 million were invalid or questionable.
Previously Reported Recommendations	Policy and guidance has not been issued for Air Force activity level capital assets. Controls were not established to ensure accuracy and completeness of PP&E. Air Force has not developed and implemented cash management training. $1.2 billion adjustment to Accumulative Operating Results was not made.

Note: This table combines the results of our review of several DBOF organizations. The table summarizes the high-dollar deficiencies identified in various accounts. All accounts were not tested at all organizations.

A statistical sample showed that $3.6 billion of the equipment-in-use account was materially misstated. Specifically, the sample results indicated that $274.6 million of assets recorded could not be located and $555.2 million of the equipment could not be verified by supporting documentation. These conditions occurred because the DBOF organizations did not reconcile equipment property records to their accounting and financial reporting records and did not maintain required supporting documentation on equipment valuations.

Expenses. Prior-year expenses of $4.7 billion were included in the calculation of Cost of Goods Sold on the FY 1996 Air Force Supply Management Business Area Statement of Operations by the DFAS Denver Center. This occurred because in preparing the FY 1996 financial statements, the DFAS Denver Center erroneously crosswalked $4.7 billion in Air Force general ledger account

code 341.15, Prior Period Adjustments, to DoD Standard general accountcode 7291.3, Inventory Losses or Adjustments, for the current year. This issue has been corrected since we brought it to the attention of the DFAS Denver Center.

Accounting Systems. The FY 1996 management representation letter by the Under Secretary of Defense (Comptroller) candidly stated that the DoD accounting systems do not provide consistent financial reporting or comparable information regarding the DBOF operations. During the FY 1996 DBOF audit, several issues pertaining to accounting systems were reported, as described in the following paragraphs.

Inventory. Air Force depot accounting and logistics systems did not have adequate edit controls to correctly record purchases and nonpurchase receipt transactions into the Supply Management Business Area general ledger accounts. Also, information from depot logistics systems did not contain sufficient contract information to correctly classify purchase transactions. Consequently, the depot accounting system accepted nonpurchase receipt transactions that overstated the Purchases at Standard Account by $763.6 million and misclassified receipt from repair transactions, which overstated the Inventory at Repair Contractors account by $711 million. An overstatement of Purchases at Standard can cause a decrease in repairable item procurement budget authority and lead to shortages of needed spare items.

Accounting Periods. Accountants recorded transactions in the wrong accounting period. This condition occurred because the Air Force Government Furnished Material and End Item Transaction Reporting System did not provide contractor on-line capability and real-time visibility to prevent erroneous transactions from being input. As a result, accounting personnel recorded transactions totaling $257.7 million into the general ledger operating materials and supplies accounts during the wrong accounting period. These misstatements affected Depot Maintenance Business Area actual operating results, unit repair costs, end item sales prices, and budgets for reimbursement of costs to the business area. During the audit, the System Functional Review Board submitted a Computer System Requirement Document to redesign the system to provide contractor on-line capability with real-time response to contractor inputs.

Materiel Returns. Materiel return transactions were not accurately reflected in accounting records and financial statements. The Army Audit Agency concluded that organizations had aged materiel return transactions valued at $167.2 million that were invalid or questionable. This condition occurred because no coordinated effort existed between logistical and financial activities to assure that the transactions making up the account balances for materiel returns were accurate.

Review of Previously Reported Weaknesses. The DoD audit community (IG, DoD, and the Military Department audit agencies) has been auditing the DBOF since FY 1992. Although progress has been made, recurring deficiencies have been identified. In the FY 1996 DBOF audit, followup work was performed on some of the previously reported weaknesses to determine whether corrective action was initiated or has been taken and whether the condition still exists.

The following is a summary of previously reported weaknesses. Not all previously reported weaknesses were reviewed during the FY 1996 DBOF audit.

DLA Property, Plant, and Equipment. The DLA financial reporting of PP&E contained material inaccuracies, lack of adequate procedures, controls, and accounting systems. DLA has made significant progress toward correcting problems identified in prior audits on reporting PP&E on the financial statements. However, three major DLA organizations reviewed did not accurately record all PP&E assets in their financial records. As a result, DLA could not produce reliable financial data. This condition occurred because the DLA organizations had not:

- allocated sufficient resources to perform directed inventories to identify all PP&E assets;

- complied with DoD reporting policy that requires DBOF organizations to report their real property facilities used in operations; and

- established the necessary procedures to ensure that accurate and reliable financial information was entered in the Defense Property and Accountability System.

DLA has taken corrective action by issuing, "Financial Recording of Capital Assets," October 17, 1994. This guidance requires DLA organizations to develop a complete listing of all capital assets by performing a complete inventory and entering the results into financial records. After this information was collected, DLA reconciled financial data at some of the reporting organizations to validate its accuracy. As a result of these efforts, the value of the reported PP&E significantly improved. Reported PP&E values increased from $319 million on the FY 1993 DLA Statement of Financial Position to $1.6 billion on the FY 1995 DLA Statement of Financial Position.

Air Mobility Command Property, Plant, and Equipment. The Air Mobility Command and the DFAS Denver Center did not take the necessary corrective actions to accurately report Air Mobility Command PP&E in the DBOF financial statements. Prior audits had concluded that Air Mobility Command PP&E accounts were understated by at least $155.5 million and that $277.6 million reported was not supported. Specifically, both the Air Mobility Command and the DFAS Denver Center had not:

- issued policy and guidance to direct the efforts of subordinate organizations toward collection of data on each capitalized asset;

- developed the specific data needed to report on each capital asset; or

- established the control process needed to ensure the accuracy and completeness of the financial data collected on PP&E.

Air Mobility Command management stated that until the DFAS Denver Center adopted a new financial information system for capital assets, corrective actions could not be initiated. Until the actions needed to improve the accuracy of PP&E reporting are taken, the $1.1 billion reported as PP&E by Air Mobility Command will continue to be questionable.

Cash Management. Prior and current audits determined that controlling cash balances in the DBOF remains a serious problem. Problems in cash management continue to exist because of congressional actions, mission-essential disbursements, inadequate cash monitoring, and insufficient cash management guidance. In addition, DoD did not fully implement audit recommendations that could have eliminated some of these problems. As a result, techniques such as advance billing, performing mission-essential work for others without adequately funded orders, inventory reductions, and transfers of funds were used to prevent cash shortages and potential Antideficiency Act violations.

DoD has attempted to improve cash management. The Director, DFAS, developed operating policies and procedures that include cash management issues. The Army provided cash managers with a cash management guide and training. The Navy developed a cash management handbook and discontinued the practice of estimating cash collections in June 1996. Additionally, DoD established a "Defense Working Capital Fund Study Group" with a cash management subcommittee.

Army. The Army Audit Agency, in following up on prior recommendations, concluded that the Army and DFAS have taken aggressive action to monitor and correct open internal control weaknesses. The Army Audit Agency followed up on 50 prior recommendations and found the following: 16 of the recommendations are no longer applicable; 26 of the recommendations have been closed, with effective action taken on 24 of them; and 8 recommendations are still open, with corrective action planned for all but one of them.

During FY 1995, Army Audit Agency reported that Inventory, Net, was understated by $1.2 billion. The understated inventory amount also caused Cost of Goods Sold to be overstated by $1.2 billion and Net Operating Results (which carried over to Accumulative Operating Results) to be understated by the same amount. During FY 1996, DFAS Indianapolis Center personnel made an accounting entry to correct the understatement of Accumulative Operating Results by increasing prior-period adjustments. However, the understated beginning inventory balance for FY 1996 was not adjusted, causing Cost of Goods Sold to be understated and Accumulative Operating Results to be overstated.

Air Force. The Air Force Audit Agency performed a review of their FYs 1992 through 1995 DBOF audits to determine whether actions had been initiated to correct the weaknesses identified in prior audits. The previously reported Air Force deficiencies included several significant problems. The systems used to process Air Force DBOF accounting transactions did not comply with Chief Financial Officers Act requirements. Continuous

organizational changes have disrupted the DBOF and inhibited accurate recording of cash collection and disbursement transactions. Internal accounting control weaknesses and noncompliance with applicable regulations have significantly affected the ability of accounting personnel to substantiate asset, liability, revenue, and expense balances. Additionally, workforce reductions, without improved automated systems, increase the potential for control weaknesses and compliance problems. Air Force auditors determined that in many of the deficient areas Air Force and DFAS personnel have ongoing or planned initiatives for improvement. However, the solutions to the critical financial management problems will require intensive efforts over the next 3 to 5 years before the Air Force can comply with the Chief Financial Officers Act.

Summary. Although progress has been made, material internal control weaknesses are a continuing problem in the DBOF. These weaknesses have been reported since the establishment of DBOF and are a major contributing factor in the disclaimer of opinion issued for the FY 1996 DBOF Consolidated Financial Statements. Weaknesses stem from the lack of controls over adjusting entries, cash management, and accountability of assets; lack of policies and procedures; deficiencies in automated systems; and failure to implement prior-year recommendations.

The United States Standard General Ledger accounts still have not been incorporated into all existing accounting systems. This forces organizations to crosswalk general ledger accounts, leaving substantial room for errors.

We will continue to identify these weaknesses until a sound internal control system is established. As stated previously, the USD(C) continues to candidly recognize the extent of procedural deficiencies in the Department's accounting and finance systems, as cited in the FY 1996 management representation letter (Appendix F).

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Part I.B. - Review of Compliance With Laws and Regulations

Introduction

We evaluated the DBOF for material instances of noncompliance with laws and regulations for the year ending September 30, 1996. Our audit objective was to assess compliance with laws and regulations for transactions and events that could have a direct and material effect on the financial statements. Such tests are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We reviewed compliance with laws and regulations to obtain reasonable assurance that the financial statements were free of material misstatements, not to render an opinion on overall compliance with such provisions. See Appendix D for a list of the laws and regulations we reviewed.

The Deputy Secretary of Defense, the USD(C), the Secretaries of the Military Departments, the Directors of affiliated DoD agencies, and the Director, DFAS, are all responsible for ensuring compliance with laws and regulations applicable to the DBOF. As part of obtaining reasonable assurance on whether the Principal Statements are free of material misstatements, we tested compliance with laws and regulations that may directly affect the financial statements and with other laws and regulations designated by the OMB and the DoD.

Since FY 1992, the USD(C) has updated sections of DoD 7220.9-M, "DoD Accounting Manual," June 17, 1991, and has incorporated those sections into new volumes of DoD 7000.14-R, "DoD Financial Management Regulation." The USD(C) had issued 14 completed volumes as of April 1997 and plans to issue one additional volume. DoD 7000.14-R, when completed, will be the single, DoD-wide regulation that all DoD Components will use for accounting, budgeting, finance, and financial management training.

Reportable Conditions

Material instances of noncompliance are failures to follow requirements, laws, or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements or that the sensitivity of the matter would cause others to perceive it as significant.

We were unable to accomplish all tests necessary to determine compliance with laws and regulations. Weak internal controls and lack of audit trails for transactions prevented us from obtaining sufficient information to fulfill this objective.

Compliance With Laws

Noncompliance with laws materially affected the reliability of the DBOF financial statements. We were unable to determine, through audit tests and procedures, the range and magnitude of noncompliance with the laws identified in Appendix D of this report.

DoD Appropriations Act. The Army and the DFAS did not comply with the provision of the DoD Appropriations Act of 1996 (Title 10, United States Code, Section 2216), which requires the use of separate accounts for transactions involving capital asset collections and disbursements. Specifically, cash collections and disbursement transactions were not separately recorded in Standard Depot System general ledger trial balances. Defense Accounting Office personnel could not record these transactions separately because needed financial transaction accounting codes were not established for the specific capital asset program accounts. As a result, depot managers did not have adequate information for planning, coordinating, and controlling about $62.9 million of FY 1996 capital asset budget authority and expenditures applicable to capital assets.

Accounting Systems. Weaknesses in DoD accounting systems have been reported since the inception of DBOF. DoD accounting systems do not comply with Federal and DoD requirements. In its FY 1996 Annual Statement of Assurance, DFAS reported that:

> The FY 1995 Chief Financial Officers (CFO) Act financial statement audits of the Department's financial statements, and the underlying financial systems and operations that produce those statements, confirmed that the Department's financial management systems were not designed to generate auditable financial statements, and demonstrated that widespread diversions from generally accepted accounting principles and DoD policy exist in many of the Department's organizations.

The systems of accounting and internal controls for the DBOF do not completely or accurately disclose the financial position of the DBOF organizations as required by Title 31, United States Code. Because of inadequacies in the DBOF internal control structure and accounting systems, there is no assurance that transactions are accurately and reliably accounted and reported for. We were unable to determine, through audit tests and procedures, the range and magnitude of noncompliance with fiscal statutes. Lack of supporting documentation and inadequate or nonexistent audit trails continue to hamper effective oversight. We are working with the USD(C) to establish integrated accounting systems and improve internal controls to ensure reasonable compliance with fiscal statutes and regulations. The Defense Accounting System Program Management Office was established to manage the consolidation and modernization of all migratory, interim migratory, and legacy accounting systems which DFAS substantially owned and operated. The long-term goals of the Program Management Office are to achieve statutory and regulatory compliance, reduce operating costs, and improve financial management reporting within DoD.

Compliance With Regulations

Widespread noncompliance with regulations materially affected the reliability of the DBOF financial statements. We were unable to determine, through audit tests and procedures, the range and magnitude of noncompliance with the regulations identified in Appendix D of this report. Table 2 illustrates instances of noncompliance with regulations and the corresponding dollar effect (if any) on the FY 1996 DBOF Consolidated Financial Statements.

DoD Financial Management Regulation. During FY 1996, numerous cases of noncompliance with the DoD 7000.14-R were identified. Some of these deficiencies have been reported in previous DBOF reports.

Property, Plant, and Equipment. Air Force Materiel Command personnel did not possess comprehensive control listings (subsidiary ledgers) that accurately summarized and reconciled to the maintenance business area PP&E balances of the general ledger control accounts. Additionally, the civil engineering records that Air Force Materiel Command, Financial Management, personnel identified as the subsidiary ledgers for the facilities in use control account varied by $1.5 billion from the general ledger control account balance. These conditions occurred because Depot Maintenance Business Area organizations did not comply with DoD 7000.14-R to maintain and reconcile subsidiary ledgers for all property account balances and Air Force Materiel Command, Financial Management, personnel did not validate that Depot Maintenance Business Area organizations had complied with established policy. As a result, the Depot Maintenance Business Area control account balances were either unsupported or varied substantially from existing ledgers.

Depreciation. Depot maintenance organizations do not have a financial system in place that allows them to compute depreciation for individual buildings as required by DoD 7000.14-R, Volume 4, "Accounting Policy and Procedures," January 1995. This problem was reported in the FY 1992 Army Audit Agency report. Since then, DoD has designated the Defense Property Accountability System as the standard DoD system to account for and depreciate real property. A DoD-level Real Property Integrated Process Team is working on policy and procedures to ensure that accurate data are loaded into the Defense System. The process team expects Army DBOF organizations to begin loading real property data into the system in FY 1998.

Accounts Payable, Federal. The Department of the Navy DBOF accounting records did not include about $80.9 million of Accounts Payable, Federal, as of June 30, 1996. This occurred because the liabilities had been inappropriately eliminated from accounts payable and not reported because they were over 9 months old. Additionally, required written requests for billings before the write-off were not maintained to show that attempts to obtain billings were made. This process is noncompliant with the DoD 7000.14-R, which requires that specific actions be taken and authority obtained prior to eliminating aged liabilities from official records.

Table 2. Instances of Noncompliance With Regulations for the FY 1996 DBOF Consolidated Financial Statements

Regulation	Issue	Impact
DoD 7000.14-R	PP&E	Subsidiary ledgers did not reconcile to PP&E general ledger accounts. Records varied by $1.5 billion from general ledger accounts.
	Depreciation	Financial system is not in place to compute depreciation for individual buildings.
	Accounts Payable Federal	Navy excluded $80.9 million of Accounts Payable that were improperly written off.
	Other Non-Fed. Governmental Liabilities	$66.7 million was unsupported; $5.8 million was invalid; $173.9 million was overstated due to misclassification.
	Military Sealift Command Accounting Sys.	System did not provide complete and sufficient financial accounting control, accuracy, verification, and support for general ledger account balances and transactions.
	Revenue Recognition	Army and Air Force used the completed unit method of recognizing revenue instead of recognizing revenue at the end of the job or as a percentage of completion.
	Reimbursement for Services	DLA was not reimbursed for services provided, which understated revenue by $150 million and caused a loss of $150 million for those services.
Fed. Financial Accounting Standard No.3	Inventory	Excess, obsolete, and unserviceable inventory was valued at standard price rather than at net realizable value.
OMB Circular A-127	Systems	Accounting systems did not comply with accounting principles, standards, and related requirements. Integrated general ledger system was not used to produce financial statements. Footnotes were not adequate.
Air Force Regulations	Equipment Depreciation	Lack of supporting documentation for capital equipment items prevented validation of $595 million in equipment and the related $330 million of depreciation.
	Adjustment Transactions	$99 million of adjustments were not supported or reviewed

Note: This table combines the results of our review of several DBOF organizations. The table summarizes the areas of noncompliance that were tested. All regulations were not tested at all organizations.

Other Non-Federal (Governmental) Liabilities. Navy DBOF accounting records included at least $66.7 million unsupported and $5.8 million invalid Other Non-Federal (Governmental) Liabilities as of June 30, 1996. Additionally, $173.9 million of federal liabilities were misclassified as non-federal liabilities and $35.6 million were over 180 days old and not

followed up on. These conditions occurred because personnel did not comply with DoD 7000.14-R, which requires organizations to maintain supporting documentation for all payables, reconcile the accounts payable balances to the supporting documentation, and record and report liabilities obtained from other Federal organizations separately from liabilities owed to non-federal sources. Invalid liabilities cause funds to be set aside unnecessarily either to pay for invoices that have been already paid or to plan for costs that have not yet occurred.

Military Sealift Command Accounting System. The Military Sealift Command financial accounting system, including automated and manual functions, contained many accounting deficiencies, had material internal control weaknesses, and was noncompliant with legal and regulatory requirements identified in the DoD 7000.14-R. This occurred because management did not adhere to DoD financial management guidance in areas such as general ledger control, financial reporting, accrual accounting, audit trails, and subsidiary ledgers. As a result, the accounting system did not provide complete and sufficient financial accounting control, accuracy, verification, and support for DoD Transportation Command and Department of the Navy General Ledger account balances and transactions.

Revenue Recognition. The Army and the Air Force did not comply with DoD 7000.14-R on the reporting of depot maintenance revenues for contracts costing less than $1 million or taking less than 12 months to complete. Both the Army and the Air Force use the completed unit method of revenue recognition for reporting depot maintenance contract revenues. DoD 7000.14-R requires revenue to be reported under the completed order method or the percentage of completion method. For contracts that begin in one fiscal year and end in another fiscal year, the completed unit method more accurately matches revenues and expenses to the period in which they are earned and incurred than does the completed order method. This issue has been reported in previous Army Audit Agency and Air Force Audit Agency DBOF reports.

The Army requested a waiver from the contract revenue recognition in FY 1995, stating that the completed unit method provides a better matching of revenues and expenses. The waiver was denied, and the Army initiated a plan to reconfigure the Standard Industrial Fund System to implement the completed contract method for applicable contracts.

We issued Audit Report No. 97-091, "Revenue Recognition Policies for the Army Defense Business Operations Fund," February 12, 1997. The report recommended that the USD(C) advise the Army to suspend making the system changes until it has been determined how DoD will implement Statement of Federal Financial Accounting Standard Number 7, "Accounting for Revenue and Other Financing Sources," May 10, 1996. DoD 7000.14-R is not in accordance with Statement of Federal Financial Accounting Standard Number 7, which mandates the use of percentage of completion for all projects, starting in FY 1998, unless there is not a material difference between the two methods. We believe the difference between the two methods would be material. The Comptroller disagreed with the recommendation and stated that the Inspector General did not show that the total amount of revenues that might be recognized

by the percentage of completion method and not recognized by the completed contract method is material or would have a material effect on the financial statements. The Army plans to continue with its current method of accounting for revenues until FY 1998. As a result, the Army will be noncompliant with DoD 7000.14-R.

DLA Distribution Depot Reimbursement. The DLA was not reimbursed for the full cost of all services provided to customers as required by DoD 7000.14-R. This occurred because the DLA had not developed a methodology to allocate the full cost of services performed to customers and had not developed stabilized rates or unit prices for all services. As a result, the DLA did not recognize $150 million of revenue for services provided to customers and consequently experienced a corresponding loss for those services.

Federal Financial Accounting Standards. Depot maintenance organizations did not value excess, obsolete, and unserviceable inventory at net realizable value in accordance with Statement of Federal Financial Accounting Standard Number 3, "Accounting for Inventory and Related Property." Maintenance organizations valued all inventory at standard price regardless of condition and therefore overvalued excess and unserviceable inventory. In their FY 1993 audit, Army Audit Agency recommended that the U.S. Army Materiel Command develop procedures for valuing excess and unserviceable inventory and that Industrial Operations Command adjust the financial statements accordingly. Both organizations agreed; however, during the FY 1996 followup audit, the organizations stated that the recommendations no longer applied because of the interpretation of the standard. The Army Audit Agency still considers the two activities to be in noncompliance with the standard.

Office of Management and Budget Circular A-127. The DFAS Indianapolis Center did not comply with OMB Circular A-127, "Financial Management Systems," as revised July, 23, 1993, in the following three areas: accounting systems, standard general ledger, and footnote disclosures. In its FY 1996 statement of annual assurance, the DFAS Indianapolis Center reported that its accounting systems did not comply with accounting principles, standards, and related requirements prescribed by OMB Circular A-127. The DFAS Indianapolis Center did not use an integrated general ledger system to produce the FY 1996 financial statements as required by OMB Circular A-127. Instead, the Center relied on budgetary execution reports that field activity commanders certified as accurate. The footnotes to the Army DBOF financial statements did not comply with the OMB Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, which requires the footnotes to "...provide additional disclosures necessary to make the principal statements fully informative and not misleading."

Other Regulations. There were several instances of noncompliance with other regulations reported during the FY 1996 audit effort.

Property, Plant, and Equipment. The Ogden and Sacramento Air Logistic Centers did not follow existing Air Force Materiel Command instructions or retain appropriate, detailed records to support the historical cost and accumulated depreciation account balances of $43 million (of the

$63.6 million reviewed) for capital equipment items. As a result, the Air Force Audit Agency could not validate the accuracy of the $595 million equipment or the related $330 million accumulated depreciation general ledger control account balances at the two Air Logistic Centers or the impact of related depreciation costs on Depot Maintenance Business Area expenses and Air Force Materiel Command sales rates.

Adjustment Transactions. DFAS personnel at the Air Logistic Centers did not properly research and document 25 of 59 adjustment transactions, valued at $99 million, to the sales clearing account and associated sales and accounts receivable accounts. This condition occurred because supervisors did not follow Air Force Regulation 177-101, "Accounting and Finance, General Accounting and Finance Systems at Base Level," February 15, 1991, to properly approve or periodically review journal vouchers to ensure proper support or because personnel did not comply with the research requirements for making adjustments to the sales clearing account.

Followup on Previously Reported Noncompliance Issues. The DFAS Centers did not consistently calculate and present expense account line items in the individual FY 1995 Statement of Operations prepared for DBOF reporting entities in the Supply Management Business Area. The lack of uniformity in reporting occurred because of conflicting guidance among OMB Bulletin No. 94-01; and Volume 11B, "Reimbursable Operations Policy and Procedures--Defense Business Operations Fund," December 1994, of DoD 7000.14-R. Followup work on the FY 1996 Statement of Operations showed that two organizations continued to use old guidance in Volume 11B to prepare the Statement of Operations. This caused $440 million in expenses to be misclassified.

Summary. Noncompliance with laws and regulations continues to be a major DBOF issue. Noncompliance issues include incomplete and inaccurate disclosure of the DBOF financial position, inadequate accounting systems, improper recognition of revenue, inadequate cash reconciliations, lack of supporting documentation, and incorrect valuation of inventory. Although progress has been made, noncompliance will continue to prevent an opinion from being issued on the DBOF financial statements until corrective action on major issues is taken.

Part II - Additional Information

Appendix A. Audit Process

Scope

Statements Reviewed. We examined the Consolidated Financial Statements of the DBOF for the year ending September 30, 1996. These financial statements were submitted to us in May 1997.

To fulfill our responsibility to express an opinion on the DBOF Consolidated Financial Statements, we coordinated our audit efforts with the Military Department audit organizations (the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency). Our combined audit efforts provide a reasonable basis for our results.

Auditing Standards. We conducted our financial related audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States (the Comptroller General), as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Statements are free of material misstatements. We relied on the guidelines suggested by the General Accounting Office (GAO) and our professional judgment in assessing the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Principals of the Joint Financial Management Improvement Program (JFMIP): the Director, OMB; the Secretary of the Treasury; and the Comptroller General. Specific standards agreed on by those officials are issued by the Director, OMB, and the Comptroller General. Financial statement reporting is governed by accounting standards approved by the JFMIP.

To date, seven accounting standards and two accounting concepts have been published in final form, and three accounting standards have been published in draft form. One other accounting standard (No. 8) has been approved by the Federal Accounting Standards Advisory Board but must undergo a congressional review before it is promulgated by OMB. OMB form and content guidance incorporates these standards and concepts and should be used by Federal agencies to prepare financial statements. Table A-1 lists the accounting standards and concepts.

Table A-1. Statements of Federal Financial Accounting Standards and Concepts

Number	Title	Status	Effective Date
Standard No. 1	Accounting for Selected Assets and Liabilities, March 30, 1993	Final	FY 1994
Standard No. 2	Accounting for Direct Loans and Loan Guarantees, August 23, 1993	Final	FY 1994
Standard No. 3	Accounting for Inventory and Related Property, October 27, 1993	Final	FY 1994
Standard No. 4	Managerial Cost Accounting Concepts and Standards for the Federal Government, July 31, 1995	Final	FY 1997
Standard No. 5	Accounting for Liabilities of the Federal Government, December 20, 1995	Final	FY 1997
Standard No. 6	Accounting for Property, Plant and Equipment, November 30, 1995	Final	FY 1998
Standard No. 7	Accounting for Revenue and Other Financing Sources, May 10, 1996	Final	FY 1998
Standard No. 8	Supplementary Stewardship Reporting	Approved	
Concept No. 1	Objectives of Federal Financial Reporting, September 2, 1993	Final	
Concept No. 2	Entity and Display, June 6, 1995	Final	

Through FY 1996, Agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, as follows:

- standards agreed to and published by the JFMIP Principals;
- form and content requirements of OMB Bulletin No. 94-01;
- accounting standards contained in agency accounting policy guidance as of March 29, 1991; and
- accounting principles published by other authoritative sources.

Beginning in FY 1997, Agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as follows:

- standards agreed to and published by the Director, OMB; the Secretary of the Treasury; and the Comptroller General;

- interpretations on the standards issued by OMB;
- requirements of the effective OMB form and content bulletin; and
- accounting principles published by other authoritative sources.

Because only three accounting standards and two accounting concepts were effective in FY 1996, most accounting standards for the "other comprehensive basis of accounting" used by DoD came from DoD accounting guidance. Previously, DoD 7220.9-M, "DoD Accounting Manual," June 17, 1991, was the primary DoD accounting guidance. Since FY 1992, the USD(C) has updated sections of DoD 7220.9-M and incorporated those sections into new volumes of DoD 7000.14-R, "DoD Financial Management Regulation." The USD(C) has issued 15 completed volumes as of April 1997. DoD 7000.14-R will be the single DoD-wide regulation that all DoD Components will use for accounting, budgeting, finance, and financial management training. However, after FY 1996, neither DoD 7220.9-M or DoD 7000.14-R will be the authoritative basis for preparing financial statements.

Overview. We also reviewed the financial information in the Overview to the DBOF FY 1996 financial statements. We did not find any instances in which the information presented in the Overview was materially inconsistent with the information presented in the Principal Statements. The information has not been audited by us; accordingly, we are not expressing an opinion.

Audit Assistance. We relied on audit assistance from the Army Audit Agency, the Naval Audit Service, and the Air Force Audit Agency. The information presented in this report is a summary of the most significant deficiencies reported by the Military Department audit organizations. Table A-2 lists the IG, DoD, and Military Department audits supporting this report.

Table A-2. Draft DBOF Reports Supporting the FY 1996 DBOF Consolidated Report

Organization	Report Title	Report/Project No.
IG, DoD	Internal Controls and Compliance With Laws and Regulations for Revenues in the FY 1996 Financial Statements of the DBOF	5FD-2020.05
	Internal Controls and Compliance With Laws and Regulations for Expense Accounts on the DBOF Consolidated Financial Statements for FY 1996	5FI-2016.03
	Air Mobility Command Financial Reporting of Property, Plant, and Equipment	97-112
	Financial Reporting of DBOF FY 1996 Property, Plant, and Equipment	5FJ-2011.03
	DLA Actions to Improve PP&E Financial Reporting	5FJ-2011.02
	DoD Cash Management in the Defense Working Capital Fund	5FH-2021.02
Army Audit Agency	Summary Report on Audits of FY 1996 Army DBOF Financial Statements	N/A
Naval Audit Agency	FY 1996 Consolidating Financial Statements of the Department of the Navy DBOF	96-002
Air Force Audit Agency	Sales and Accounts Receivable, Supply Management Business Area, FY 1996	96068013
	Air Force DBOF Cash Management, and Property, Plant, and Equipment, FY 1996	96068011
	Government Furnished Material and End Item Transaction Reporting System (G009)	96068009
	Overall Assessment of the Air Force DBOF	96068008

Scope of the Review of Internal Controls. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. We reviewed internal controls related to the FY 1996 DBOF Consolidated Financial Statements. Our previous audits disclosed an inadequate internal control structure, along with significant deficiencies with the accounting systems within

the DBOF. This inadequate internal control structure and system deficiencies precluded us from placing any reliance on internal controls or rendering an opinion on the financial statements. This remains the basis for our disclaimer of opinion for FY 1996. Therefore, we revised our planned audit work to focus on reviewing internal controls in more detail.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

Scope of the Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of the DBOF's managers. To obtain reasonable assurance that the DBOF consolidated financial statements were free of material misstatements, we performed tests of compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by the OMB and DoD. See Appendix D for a list of laws and regulations reviewed.

We did not review management's implementation of DoD Directive 5010.38,* "Internal Management Control Program," April 14, 1987, because of the lack of a sound internal control structure within the DBOF. We revised our audit approach accordingly to focus on specific internal controls.

Representation Letter. We received a management representation letter from the USD(C), dated April 9, 1997, regarding the FY 1996 DBOF Consolidated Financial Statements. The letter cites major deficiencies in the accounting systems and the standard general ledger, as well as internal control weaknesses and compliance problems for many DBOF accounts. See Appendix F for the management representation letter from the USD(C). We received a legal representation letter from the General Counsel of the Department of Defense dated March 24, 1997.

Methodology

Computer-Processed Data. Based on management's representation and on the audit work that we performed along with the Military Department audit organizations, we concluded that computer-processed data were not completely reliable.

Audit Period and Locations. The audit was conducted from January 1996 to April 1997 at various offices of the DFAS and the Military Department business areas that are part of the DBOF.

*DoD Directive 5010.38 has been revised as "Management Control Program," August 26, 1996. The audit was performed under the April 1987 version of the directive.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD except for OMB, GAO, and Treasury. Further details are available on request.

Appendix B. Prior Coverage

Consolidated DBOF Reports

IG, DoD, Report No. 97-006, "Major Accounting and Management Control Deficiencies in the Defense Business Operations Fund in FY 1995," October 15, 1996. We reported that the DFAS continues to prepare financial statements that do not fairly present the financial position of the DBOF. The financial statements are unreliable, inconsistent, and inaccurate. This situation has been caused by management's inability to implement a control structure that enables DBOF accounting systems to effectively compile and report accurate financial information. Control weaknesses were categorized as follows:

- Accounting systems (supporting suites, standard general ledger, documentation, audit trails, and intrafund transactions).

- Control procedures (guidance).

- Control environment (PP&E, inventory evaluation, personnel, and previously noted control weaknesses).

As a result, Congress and the DoD managers have not been able to effectively use DBOF financial statements and underlying systems for management oversight. Inadequate management controls, if not corrected, could adversely affect the implementation of the DBOF migratory systems strategy. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 96-178, "Internal Controls and Compliance With Laws and Regulations for the Defense Business Operations Fund Consolidated Financial Statements for FY 1995," June 26, 1996. We were unable to render an opinion on the FY 1995 DBOF Consolidated Financial Statements. The disclaimer of opinion can be attributed to deficiencies in the internal control structure of the financial systems and noncompliance with laws and regulations. As a result, the financial position of the Defense Business Operation Fund could not be determined or presented in a fair and timely fashion.

The lack of standard general ledger accounts and basic accounting knowledge caused expenses, revenues, accounts receivable, liabilities, and accounts payable to either be misstated or understated. Assets were incorrectly reported and recorded with incorrect charges to depreciation. Both the misstatement of revenue and cash disbursements not being validated prior to payments was caused by the lack of sound accounting procedures. Accounts could not be validated because of the absence of supporting documentation. Failure to comply with Title 31, United States Code, and noncompliance in accounting

systems; accounting estimates; cash recalculations; inventory valuation; facilities, equipment, and software; and revenue recognition materially affected the fair presentation of the financial statements for the Defense Business Operations Fund. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 95-294, "Major Accounting Deficiencies in the Defense Business Operations Fund in FY 1994," August 18, 1995. We reported that the DBOF has not been able to prepare financial statements that fairly present the DBOF financial position since its establishment in 1991. The financial statements prepared are untimely, unreliable, inconsistent, and inaccurate. As a result, Congress and DoD managers cannot effectively use the DBOF financial statements and underlying systems for management oversight. Additionally, the unauditable financial systems reflect the inadequate internal control structure within DBOF, which negatively affects day-to-day operations. Major deficiencies identified during the audit can be grouped into accounting system characteristics and overall management issues. The DBOF accounting and financial systems compile information inefficiently. A major obstacle to the development and use of reliable financial statements is the lack of a universally implemented standard general ledger. Currently, the DoD Standard General Ledger is partially implemented in a few DoD accounting systems; other systems use crosswalks in an attempt to recategorize data. Insufficient documentation and poor audit trails characterize many DBOF accounting and financial systems. Additionally, inadequate accounting for intrafund transactions contributes to significant distortions on the financial statements. The report stated that several DFAS centers either do not have in place, or do not fully use, automated reasonableness and edit checks. Failure to use such checks results in incorrect financial statements, and excessive time and effort must be spent in correcting avoidable accounting problems. Furthermore, footnote disclosures to the financial statements issued by the DFAS centers did not provide accurate overviews and supplemental information.

Deficiencies existed in the overall management of the DBOF accounting and finance systems. Many accounting problems at DoD organizations and on DBOF financial statements could be attributed to deficient DBOF guidance. The guidance was not always properly distributed or understood, was not up to date, or was not developed in some cases. Additionally, inadequate accounting for many items of PP&E materially distorted the preparation and presentation of the FY 1994 DBOF financial statements. Also, because of inaccurate valuation in DoD inventory accounts and misclassification in other line item accounts, preparation of financial statements was flawed, and financial statements were not usable. Finally, development and use of the financial statements were adversely affected by problems with accounting personnel, such as inadequate training, shortages of support personnel, poor communication between field offices and headquarters, loss of corporate knowledge, and a lack of documented procedures. No recommendations were made in this report; therefore, management comments were not required. The Under Secretary of Defense (Comptroller) concurred with the report.

IG, DoD, Report No. 95-267, "Defense Business Operations Fund Consolidated Statement of Financial Position for FY 1994," June 30, 1995. We were unable to render an opinion on the FY 1994 DBOF Consolidated Statement of Financial Position because of the lack of a sound internal control structure; noncompliance with regulations; and deficiencies in the accounting systems, all of which prevented the preparation of accurate financial statements. Material internal control weaknesses were found in each of the accounts reviewed. The Air Force Inventory In-Transit account for business organizations had a negative balance. A negative balance in an inventory account indicates an internal control problem in the accounting system that produces those figures; therefore, the system cannot be relied on. Several conditions were noted in accounts receivable for the Defense Logistics Agency Distribution Depot and Air Force Depot Management business areas. For example, misstatements occurred because transactions were unsupported and unverified; the incorrect recording of accounts receivable caused overstatements in the account; weak internal controls caused reimbursements to be collected but not posted or recorded; and funding documents were not received, which prevented the organizations from billing customers. The DLA PP&E account was materially understated. The Navy PP&E account was overstated because assets could not be located; costs were unsupported; and assets were incorrectly recorded. The IG, DoD; the Naval Audit Service; and the Air Force Audit Agency found reportable conditions in accounts payable that affected the reliability of the balances. The conditions included accounting errors, negative balances, and accounts payable disbursements that were not posted to the accounts payable balance; accounts payable disbursements that were not recorded; and a lack of supporting documentation. The Army's Other Intragovernmental Liabilities account contained invalid transactions, but adjustments were made to the financial statements before the yearend account balances were submitted to DFAS Indianapolis Center. The Navy Other Liabilities account was overstated because of system-wide processing problems. The Navy did not include the required Intrafund Elimination note to the financial statements because the Navy did not have the procedures needed to collect data for the note to the financial statements.

We reported several instances of noncompliance with laws and regulations. DoD did not comply with the Federal Financial Management Act of 1994, which established a deadline of March 31, 1995, to provide unaudited FY 1994 financial statements to OMB. This delay was caused in part by the Navy. The report stated that the systems for accounting and internal controls did not completely or accurately disclose the financial position of the DBOF organizations as required by Title 31, United States Code. The FY 1994 DFAS Annual Statement of Assurance reported that the majority of the financial management systems did not meet the requirements of OMB Circular No. A-127. One of the systems used by Army Supply Management was not using standard general ledger accounts, as required by DoD 7220.9-M. Most Army depot maintenance organizations did not have an accounting system that allows them to compute depreciation on separate buildings, as required by DoD 7000.14-R. The Army did not comply with Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," October 27, 1993, which states that inventory should be revalued to its latest acquisition cost at year's end. The Navy and two Defense Accounting

Offices used estimated figures, contrary to DoD 7220.9-M guidance, which prohibits estimates in the Statement of Accountability. No recommendations were made in this report; therefore, management comments were not required. The USD(C) generally concurred with the report. The Navy objected to our statement that the audit was impeded in part because Navy management made repeated adjustments to the Navy DBOF financial statements. We responded that the Navy's comments failed to consider the requirement in the Federal Financial Management Act of 1994 to submit the FY 1994 DBOF financial statements to OMB by March 31, 1995.

IG, DoD, Report No. 94-161, "Consolidated Statement of Financial Position of the Defense Business Operations Fund for FY 1993," June 30, 1994. We were unable to render an opinion on the FY 1993 DBOF Consolidated Statement of Financial Position because of significant internal control deficiencies and noncompliance with regulations. We reported numerous internal control problems associated with four accounts of the DBOF financial statements. The principal problems in the Fund Balance With Treasury account were the definition of the account and the reconciliation of balances. The DoD definition of this account was not consistent with accounting principles, which made the balance misleading. Additionally, the individual organizations could not reconcile their own portions of the account because the information was integrated with other DoD Fund Balance With Treasury information. Misstatements were reported for the Defense Logistics Agency and the Navy for this account. The Inventory Held for Sale, Net, account and the Inventory Not Held for Sale account had valuation and classification problems and material discrepancies. Specifically, for the Inventory Not Held for Sale account, negative inventory balances were reported, and the accuracy of War Reserve assets could not be verified. The Army and the Air Force did not maintain appropriate source documentation for items included in the PP&E account, which made those portions of the account unauditable. Also, the Air Force did not report all PP&E items in the DBOF financial statements. Additionally, the PP&E account for the Joint Logistics Systems Center was misstated because that organization did not implement an effective internal control program.

We reported numerous instances of noncompliance with regulations. The DFAS Indianapolis Center did not use an integrated general ledger to produce the FY 1993 financial statements, as required by OMB guidance, and several Army DBOF supply systems did not use the standard general ledger system required by DoD 7220.9-M. We also reported that the Defense Logistics Agency did not effectively implement an internal management control program for reporting the results of physical inventories. Also, the Army valued all inventories at standard price, but the Defense Logistics Agency valued only reutilization and marketing inventories at standard price. Neither of those valuation policies adheres to the Statement of Federal Financial Accounting Standards Number 1, "Accounting for Selected Assets and Liabilities," March 30, 1993. We also reported that most Army Depot Maintenance organizations did not have accounting systems that allowed them to compute depreciation for separate buildings, as required by DoD 7220.9-M. Finally, the Notes to the FY 1993 DBOF Financial Statements did not comply with "DoD Guidance on Form and Content on Financial Statements for FY 1993 and FY 1994 Financial

Activity." The financial statements included only 4 notes, not the required 26. No recommendations were made in this report; therefore, management comments were not required, and none were received.

IG, DoD, Report No. 93-134, "Principal and Combining Financial Statements of the Defense Business Operations Fund - FY 1992," June 30, 1993. We were unable to render an opinion on the FY 1992 DBOF Financial Statements because audit trails were inadequate, accounting systems were inadequate, significant internal control deficiencies existed, significant instances of noncompliance with regulations were found, and legal and management representation letters were not received. We reported numerous material internal control weaknesses that affected the reliability of the FY 1992 financial statements. Transactions were not properly recorded and accounted for because controls over cash were inadequate, transactions by and for others were not recorded in a timely manner, intrafund transactions were not eliminated or reported, and certain accounts were not properly accounted for. We could not ensure that assets were safeguarded from unauthorized use because supporting documentation was lacking and because the capital asset and inventory accounts were not correctly valued and we could not determine whether these accounts existed. Transactions were not executed in compliance with existing guidance. Reconciliations, uniform accounting systems, and a standard general ledger were lacking, and the weekly flash cash reports were unreliable.

Several instances of noncompliance with laws and regulations materially affected the reliability of the FY 1992 financial statements. The DBOF accounting systems did not meet the requirements of the Budget and Accounting Procedures Act of 1950 and the GAO "Policy and Procedures Manual for Guidance of Federal Agencies," Title 2, "Accounting." The USD(C) was not in full compliance with OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," which implemented the Chief Financial Officers Act. In addition, quarterly and annual reports to the Department of the Treasury on Accounts and Loans Receivable Due From the Public were not accurately prepared. Air Force Supply Management did not follow requirements of DoD 7220.9-M. Real properties were improperly reflected as assets on the DBOF financial statements and did not comply with the requirements for Real Property Ownership under Title 10, United States Code, Section 2682. Also, the DFAS Columbus Center and the Defense Commissary Agency did not meet certain provisions of the Prompt Payment Act. No recommendations were made in this report; therefore, management comments were not required. However, we received comments from the Acting Chief Financial Officer. Management generally agreed with the report, but took exception to our reportable conditions on inadequate audit trails and reported instances of noncompliance with GAO Title 2; the Budget and Accounting Procedures Act of 1950; OMB Bulletin No. 93-02; and the National Defense Authorization Act.

Related Audit Reports

Report No.	Title	Date
General Accounting Office		
AIMD-96-54	Defense Business Operations Fund (DBOF): DoD Is Experiencing Difficulty in Managing the Fund's Cash (OSD Case No. 1109)	April 1996
AIMD-95-79	DBOF: Management Issues Challenge Fund Implementation (OSD Case No. 9859)	March 1, 1995
AIMD-94-80	Financial Management, Status of the DBOF (OSD Case No. 9339-D)	March 9, 1994
Inspector General, Department of Defense		
97-006	Major Accounting and Management Control Deficiencies in the DBOF in FY 1995	October 15, 1996
96-178	Internal Controls and Compliance with Laws and Regulations for the DBOF Consolidated Financial Statements for FY 1995	June 26, 1996
95-294	Major Accounting Deficiencies in the DBOF in FY 1994	August 18, 1995
95-267	DBOF Consolidated Statement of Financial Position for FY 1994	June 30, 1995
95-072	Defense Finance and Accounting Service Work on the FY 1993 Air Force DBOF Financial Statements	January 11, 1995
95-067	Defense Finance and Accounting Service Work on the Air Force FY 1993 Financial Statements	December 30, 1994
95-066	Application Controls - Navy Inventories	December 30, 1994
95-034	Development of Property, Plant, and Equipment Systems	November 21, 1994
95-023	Application Controls Over Selected Portions of the Standard Army Intermediate Level Supply System	November 4, 1994

Appendix B. Prior Coverage

Report No.	Title	Date
94-199	Research on Accounting and Financial Reporting at the Defense Information Services Organization	September 30, 1994
94-183	Controls Over Commissary Revenues	September 6, 1994
94-168	Defense Finance and Accounting Service Work on the Army FY 1993 Financial Statements	July 6, 1994
94-167	Selected Financial Accounts on the Defense Logistics Agency DBOF Financial Statements for FY 1993	June 30, 1994
94-163	Management Data Used to Manage the U.S. Transportation Command and Military Department Transportation Organizations	June 30, 1994
94-161	Consolidated Statement of Financial Position of the DBOF for FY 1993	June 30, 1994
94-159	Fund Balances With Treasury Accounts on the FY 1993 Financial Statements of the Defense Logistics Agency Business Areas of the DBOF	June 30, 1994
94-150	Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the DBOF for FY 1993	June 28, 1994
94-149	Property, Plant and Equipment Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the DBOF for FY 1993	June 28, 1994
94-147	Joint Logistics System Center's Financial Statements for FY 1993	June 24, 1994
94-128	Management Data Used to Manage the Defense Logistics Agency Supply Management Division of the DBOF	June 14, 1994
94-082	Financial Management of the DBOF - FY 1992	April 11, 1994
93-164	Financial Statements of DLA Supply Management Division of the DBOF (Defense Fuel Supply Center Financial Data) for FY 1992	September 2, 1993

Report No.	Title	Date
93-153	DBOF Communication Information Services Activity Financial Statements for FY 1992	August 6, 1993
93-151	Compliance With the Federal Managers' Financial Integrity Act at the Defense Commercial Communications Office	July 26, 1993
93-147	Defense Commissary Resale Stock Fund Financial Statements for FY 1992	June 30, 1993
93-134	Principal and Combining Financial Statements of the DBOF for FY 1992	June 30, 1993

Army Audit Agency

AA 96-186	DBOF Depot Maintenance, Other, Army FY 95 Statement of Operations	June 13, 1996
AA 96-185	DBOF Supply Management, Army FY 95 Statement of Operations	April 30, 1996
NR 95-430	Army DBOF FY 94 Financial Statements	July 19, 1995
NR 94-471	Army DBOF FY 93 Financial Statements: Report of Management Issues	September 29, 1994
NR 94-470	Army DBOF FY 93 Financial Statements: Audit Opinion	June 30, 1994
NR 94-457	DBOF, FY 92 Financial Statements: Common Management Issues	March 30, 1994
NR 94-456	DBOF, Transportation, Army FY 92 Financial Statements: Report of Management Issues	March 30, 1994
NR 94-454	DBOF, Depot Maintenance, Army FY 92 Financial Statements: Report of Management Issues	March 30, 1994
NR 93-463	DBOF Depot Maintenance, Army	June 30, 1993
NR 93-462	DBOF Transportation, Army	June 30, 1993

Appendix B. Prior Coverage

Report No.	Title	Date
Naval Audit Service		
035-96	FY 1995 Consolidating Financial Statements of the Department of Navy DBOF	May 31, 1996
044-95	FY 1994 Consolidating Financial Statements of the Department of the Navy DBOF	May 30, 1995
010-95	Sponsor-Funded Equipment at Selected Navy DBOF Activities	December 2, 1994
053-H-94	FY 1993 Consolidating Financial Statements of the Department of the Navy DBOF	June 29, 1994
053-H-93	FY 1992, Consolidating Financial Statements of the Department of the Navy DBOF	June 30, 1993
Air Force Audit Agency		
95068021	Review of Selected Accounts, Depot Maintenance Service Business Area FY 1995	September 13, 1996
95068020	Review of Selected Accounts, Supply Management Business Area, FY 1995	August 20, 1995
94068027	Followup Audit--Review of Prior Year DBOF Recommendations	October 25, 1995
94068042	Followup Audit--Review of Prior Year DBOF Recommendations	August 18, 1995
94068039	Review of Selected Accounts, Depot Maintenance Service Business Area, FY 1994	July 28, 1995
94068041	Review of Selected Accounts, Supply Management Business Area, FY 1994	June 27, 1995
93066011	Review of Application Controls Within the Depot Maintenance Equipment Program	November 16, 1994
93066012	Review of Application Controls Over Time and Attendance Reporting in Air Force Materiel Command Depot Maintenance Organizations	November 4, 1994

Report No.	Title	Date
93066024	Review of Application Controls Within the Financial Inventory Accounting and Billing System	October 3, 1994
94068020	Opinion on Air Force DBOF, FY 1993 Fund Balances With Treasury	June 30, 1994
94068019	Opinion on Air Force DBOF, FY 1993 Property, Plant and Equipment Balances	June 30, 1994
94068018	Opinion on Air Force DBOF, FY 1993 Inventories Not Held for Sale Balance	June 30, 1994
94068017	Opinion on Air Force DBOF, FY 1993 Inventories Held for Sale Balance	June 30, 1994
93066023	Review of Application Controls Within the Depot Maintenance Actual Materiel Cost System	June 10, 1994
94068025	Air Force Depot Maintenance Service, FY 1993 Material In-Transit Balances	April 1, 1994
93068001	Compliance With Laws and Regulations and Management Issues Related to Air Force Supply Management and Distribution Depot, FY 1992 Financial Statements	December 15, 1993
92066008	Review of the Design and Development Activities for the Depot Maintenance Management Information System	August 18, 1993
93068024	Opinion on Air Force Consolidating Statements, DBOF, FY 1992 Financial Statements	June 30, 1993
93068012	Opinion on Air Force Distribution Depot, DBOF, FY 1992 Financial Statements	June 30, 1993
93068011	Opinion on Air Force Supply Management, DBOF, FY 1992 Financial Statements	June 30, 1993
92068003	Opinion on Laundry and Dry Cleaning Service, DBOF, FY 1992 Financial Statements	June 30, 1993
92068002	Opinion on Air Force Depot Maintenance, DBOF, FY 1992 Financial Statements	June 30, 1993

Appendix B. Prior Coverage

Report No.	Title	Date
92071002	Opinion on Air Force Transportation, DBOF, FY 1992 Financial Statements	June 29, 1993
92066010	Review of General and Application Controls Within the Contract Depot Maintenance Production and Cost System	April 1, 1993
92066002	Review of General and Application Controls Within the Equipment Inventory, Multiple Status and Utilization Reporting Subsystem	April 1, 1993
92062001	Review of Depot Maintenance Industrial Fund Revenue Accounts, FY 1992 Financial Statements	February 28, 1993

Appendix C. Financial Statements and Auditor Opinion

DEFENSE BUSINESS OPERATIONS FUND

CONSOLIDATED STATEMENTS

10

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Financial Position
As of September 30, 1996
(Thousands)

ASSETS	1996	1995
1. Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$4,401,666	$4,656,849
(2) Investments, Net (Note 4)	0	0
(3) Accounts Receivable, Net (Note 5)	5,165,568	6,239,154
(4) Interest Receivable	0	0
(5) Advances and Prepayments	116,440	297,966
(6) Other Federal (Intragovernmental) (Note 6)	954,437	644,682
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Investments (Note 4)	0	0
(2) Accounts Receivable, Net (Note 5)	2,206,857	2,278,308
(3) Credit Program Receivables/ Related Foreclosed Property, Net (Note 7)	0	0
(4) Interest Receivable, Net	81	57
(5) Advances and Prepayments	880,318	830,989
(6) Other Non-Federal (Governmental) (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	1	2
d. Inventory, Net (Note 8)	60,309,149	59,887,675
e. Work in Process (Note 9)	2,526,277	2,680,960
f. Operating Materials/Supplies, Net (Note 10)	1,536,660	1,501,927
g. Stockpile Materials, Net (Note 11)	0	152,855
h. Seized Property (Note 12)	0	0
i. Forfeited Property, Net (Note 13)	0	0
j. Goods Held Under Price Support and Stabilization Programs, Net (Note 14)	0	0
k. Property, Plant and Equipment, Net (Note 15)	12,265,885	11,948,382
l. Other Entity Assets	1,414,305	1,547,858
m. Total Entity Assets	$91,777,644	$92,667,664
2. Non-Entity Assets:		
a. Transactions With Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$21,937	$18,290
(2) Accounts Receivable, Net (Note 5)	0	0
(3) Interest Receivable, Net	0	0
(4) Other (Note 6)	375,620	733,297

The accompanying notes are an integral part of these statements.

11

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Financial Position
As of September 30, 1996
(Thousands)

ASSETS, Continued	1996	1995
2. Non-Entity Assets:		
b. Transactions With Non-Federal (Governmental) Entities:		
(1) Accounts Receivable, Net (Note 5)	$0	$0
(2) Interest Receivable, Net	0	0
(3) Other (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Other Non-Entity Assets	38,362	45,685
e. Total Non-Entity Assets	$435,919	$797,272
3. Total Assets	$92,213,563	$93,464,936
LIABILITIES		
4. Liabilities Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$2,658,519	$3,115,657
(2) Interest Payable	0	0
(3) Debt (Note 16)	1,382,763	1,432,108
(4) Other Federal (Intragovernmental) Liabilities (Note 17)	5,546,273	7,282,783
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	3,544,885	3,526,745
(2) Accrued Payroll and Benefits		
(a) Salaries and Wages	768,690	552,310
(b) Annual Accrued Leave	810,068	721,905
(c) Severance Pay and Separation Allowance	0	0
(3) Interest Payable	251	2
(4) Liabilities for Loan Guarantees (Note 7)	0	0
(5) Lease Liabilities (Note 18)	3,622	3,622
(6) Pensions and Other Actuarial Liabilities (Note 19)	33	469
(7) Other Non-Federal (Governmental) Liabilities (Note 17)	3,504,040	3,422,972
c. Total Liabilities Covered by Budgetary Resources:	$18,219,144	$20,058,573

The accompanying notes are an integral part of these statements.

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Financial Position
As of September 30, 1996
(Thousands)

LIABILITIES, Continued	1996	1995
5. Liabilities Not Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$0	$18,290
(2) Debt (Note 16)	0	0
(3) Other Federal (Intragovernmental) Liabilities (Note 17)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	0	0
(2) Debt (Note 16)	0	0
(3) Lease Liabilities (Note 18)	0	0
(4) Pensions and Other Actuarial Liabilities (Note 19)	48,886	0
(5) Other Non-Federal (Governmental) Liabilities (Note 17)	86,985	190,014
c. Total Liabilities Not Covered By Budgetary Resources	$135,871	$208,304
6. Total Liabilities	$18,355,015	$20,266,877
NET POSITION (Note 20)		
7. Balances:		
a. Unexpended Appropriations	$1,324,293	$7,455
b. Invested Capital	113,173,469	99,512,198
c. Cumulative Results of Operations	(33,826,228)	(20,963,206)
d. Other	(6,677,115)	(5,150,084)
e. Future Funding Requirements	(135,871)	(208,304)
f. Total Net Position	$73,858,548	$73,198,059
8. Total Liabilities and Net Position	$92,213,563	$93,464,936

The accompanying notes are an integral part of these statements.

13

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Operations and Changes in Net Position
For the Period Ended September 30, 1996
(Thousands)

	1996	1995
REVENUES AND FINANCING SOURCES		
1. Appropriated Capital Used	$852,654	$14,603
2. Revenues from Sales of Goods and Services		
a. To the Public	6,622,847	9,741,083
b. Intragovernmental	65,735,629	65,982,683
3. Interest and Penalties, Non-Federal	0	0
4. Interest, Federal	0	0
5. Taxes (Note 21)	0	0
6. Other Revenues and Financing Sources (Note 22)	497,984	857,435
7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies	0	0
8. **Total Revenues and Financing Sources**	$73,709,114	$76,595,804
EXPENSES		
9. Program or Operating Expenses (Note 23)	$11,810,594	$7,781,468
10. Cost of Goods Sold (Note 24)		
a. To the Public	5,941,338	7,315,277
b. Intragovernmental	54,860,679	55,823,923
11. Depreciation and Amortization	852,336	833,555
12. Bad Debts and Writeoffs	11,984	23,463
13. Interest		
a. Federal Financing Bank/Treasury Borrowing	0	0
b. Federal Securities	0	0
c. Other	653	14,514
14. Other Expenses (Note 25)	2,911,104	8,344,789
15. **Total Expenses**	$76,388,688	$80,136,989
16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items	($2,679,574)	($3,541,185)
17. Plus (Minus) Extraordinary Items (Note 26)	428,259	(6,538,793)
18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	($2,251,315)	($10,079,978)

The accompanying notes are an integral part of these statements.

14

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Operations and Changes in Net Position
For the Period Ended September 30, 1996
(Thousands)

EXPENSES, Continued	1996	1995
19. Net Position, Beginning Balance, as Previously Stated	$76,930,111	$85,497,457
20. Adjustments (Note 27)	(5,625,878)	1,402,641
21. Net Position, Beginning Balance, as Restated	$71,304,233	$86,900,098
22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	(2,251,315)	(10,079,978)
23. Plus (Minus) Non Operating Changes (Note 28)	4,805,630	(3,622,061)
24. Net Position, Ending Balance	$73,858,548	$73,198,059

The accompanying notes are an integral part of these statements.

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Cash Flows
For the Period Ended September 30, 1996
(Thousands)

	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES		
1. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	($2,251,315)	($10,079,978)
Adjustments affecting Cash Flow:		
2. Appropriated Capital Used	(791,862)	(14,603)
3. Decrease (Increase) in Accounts Receivable	313,738	620,753
4. Decrease (Increase) in Other Assets	(725,609)	10,326,451
5. Increase (Decrease) in Accounts Payable	309,858	1,253,805
6. Increase (Decrease) in Other Liabilities	(424,325)	1,108,321
7. Depreciation and Amortization	852,335	849,641
8. Other Unfunded Expenses	(3,323)	(171,027)
9. Other Adjustments	3,545,218	(1,246,466)
10. Total Adjustments	$3,076,030	$12,726,875
11. Net Cash Provided (Used) by Operating Activities	$824,715	$2,646,897
CASH FLOWS FROM INVESTING ACTIVITIES		
12. Sale of Property, Plant and Equipment	$133,879	$9,069
13. Purchase of Property, Plant and Equipment	(1,480,787)	(505,392)
14. Sale of Securities	0	0
15. Purchase of Securities	0	0
16. Collection of Loans Receivable	0	0
17. Creation of Loans Receivable	0	0
18. Other Investing Cash Provided (Used)	0	0
19. Net Cash Provided (Used) by Investing Activities	($1,346,908)	($496,323)
CASH FLOWS FROM FINANCING ACTIVITIES		
20. Appropriations (Current Warrants)	$878,700	$1,117,870
21. Add:		
a. Restorations	0	0
b. Transfers of Cash from Others	4,579,180	3,885,964
22. Deduct:		
a. Withdrawals	0	0
b. Transfers of Cash to Others	5,132,906	4,956,838
23. Net Appropriations	$324,974	$46,996

The accompanying notes are an integral part of these statements.

16

Principal Statements

Department of Defense
Defense Business Operations Fund
Statement of Cash Flows
For the Period Ended September 30, 1996
(Thousands)

CASH FLOWS FROM FINANCING ACTIVITIES, Continued	1996	1995
24. Borrowing from the Public	$0	$0
25. Repayments on Loans to the Public	0	0
26. Borrowing from the Treasury and the Federal Financing Bank	0	0
27. Repayments on Loans from the Treasury and the Federal Financing Bank	(49,344)	0
28. Other Borrowings and Repayments	0	0
29. Net Cash Provided (Used) by Financing Activities	$275,630	$46,996
30. Net Cash Provided (Used) by Operating, Investing and Financing Activities	($246,563)	$2,197,570
31. Fund Balance with Treasury, Cash, and Foreign Currency, Beginning	4,648,229	2,459,287
32. Fund Balance with Treasury, Cash, and Foreign Currency, Ending	$4,401,666	$4,656,857

Supplemental Disclosure of Cash Flow Information:	1996	1995
33. Total Interest Paid	$3,062	$14,512

Supplemental Schedule of Financing and Investing Activity:	1996	1995
34. Property and Equipment Acquired Under Capital Lease Obligations	$0	$0
35. Property Acquired Under Long-Term Financing Arrangements	$0	$0
36. Other Exchanges of Non-cash Assets or Liabilities	$1,417,377	$1,387,797

The accompanying notes are an integral part of these statements.

17

Principal Statements

The accompanying notes are an integral part of these statements.

18

Footnotes to the Consolidated Statements

NOTE 1. Summary of Significant Accounting Policies

A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Defense Business Operations Fund (DBOF), as required by the Chief Financial Officers (CFO) Act of 1990, and other appropriate legislation. The information used was derived from a consolidation of the reports provided by the various DoD components. The statements were prepared in accordance with DoD guidance on the form and content of the financial statements as adopted from OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," and subsequent issues. Information on classified operations has been aggregated and reported in such a manner that it is no longer classified. Intrafund eliminations were included for Army and Navy installations only. At this time accounting systems in use by other entities do not have the capability of breaking out intra-elimination information. The amounts presented in the financial statements are rounded to the nearest thousands of dollars. Individual business area statement line items may not total to the consolidating statements as a result of rounding.

B. Reporting Entity

Historically the individual DoD entities have operated a significant number of its organic commercial and industrial facilities under a revolving fund concept. Beginning in FY 1991 these funds were consolidated to form the Defense Business Operation Fund represented by basic symbol 97X4930.

C. Budgets and Budgetary Accounting

DBOF is financed through working capital revolving funds designed to provide an effective means of financing, budgeting, accounting for, and controlling inventory, as well as the costs of providing goods and services used to support both peacetime and wartime operations.

The DoD expanded the use of business like financial management practices through the establishment of the DBOF on October 1, 1991. The fund operates with financial principles that provide improved cost visibility and accountability to enhance business management and improve the decision making process. The fund builds on revolving fund principles previously used for industrial and commercial-type activities.

Footnotes

The Department's working capital funds are primarily included within the Fund and finance industrial and commercial type transactions. Supply Management and Distribution Depot funds are composed of four divisions administered by the Departments of the Army, Navy, Air Force and the Defense Logistics Agency. These activities provide supplies and inventories to the Department organizations on a commercial basis. Receipts derived from resale operations are normally available in their entirety for use without further congressional action. In fiscal year 1996, these revolving funds recorded an operating deficit of $2.813 billion.

Supply Management and Distribution Depot
Sales, Costs of Sales and Expenses,
and Net Operating Results by Division
(in thousands)

Division	Sales	Cost of Sales and Expenses	Net Operating Results
Army	$ 10,505,150	$ 10,316,617	$ 188,533
Navy	6,687,096	10,764,153	(4,077,057)
Air Force	12,788,660	10,626,088	2,162,572
Defense Agencies	19,200,813	20,287,390	(1,086,577)
Total	$ 49,181,719	$ 51,994,248	($ 2,812,529)

Amounts shown are after extraordinary items and before eliminations.

The Department's industrial funds are also included within the Fund and are composed of four divisions: Army, Navy, Air Force, and Defense Agencies. These divisions provide services to other DoD Components through buyer-seller relationships. Airlift/sealift, Navy research and development, and depot maintenance comprise the most significant portion of the fund activity accounting for 77 percent of the total fund revenues in fiscal year 1996. The fund recorded an operating profit of $610 million in fiscal year 1996 due to industrial fund type work.

Depot Maintenance
Revenues, Expenses, and Net Operating Results by Division
(in thousands)

Division	Revenues	Expenses	Net Operating Results
Army	$ 2,236,292	$ 2,154,093	$ 82,199
Navy	17,691,416	17,058,786	632,630
Air Force	4,501,535	4,539,823	(38,288)
Defense Agencies	8,625,499	8,691,940	(66,441)
Total	$ 33,054,742	$ 32,444,642	$ 610,100

Amounts shown are after extraordinary items and before eliminations.

Footnotes

D. Basis of Accounting

Transactions are recorded on an accrual accounting basis and a budgetary basis. Under the accrual method, revenues are recognized when earned; expenses are recognized in the period a liability is incurred. Supply Management business area recognizes the cost of goods sold or services provided and revenue when items are shipped or, if Foreign Military Sales customers, when the item is accepted. Budgetary accounting through unique general ledger accounts facilitates compliance with legal constraints and controls over the use of federal funds. Accounting policy requires the installation to record the accrual based on receipt of the receiving report.

E. Revenues and Other Financing Sources

Revolving fund appropriations are funded by revenues generated by sales of goods or services through a reimbursable order process. This process allows the seller to increase funds available by increasing the cost of the supplies and/or services supplied to the customer. Funds received prior to delivery of the goods or services are treated as unearned revenue and recorded as a liability.

F. Funds with U. S. Treasury

It was determined that cash control for the Defense Business Operations Fund would be maintained by the Army, Navy, Air Force, and the Defense Logistics Agency (for all Defense Agencies). Therefore, receipt and disbursement balances are transferred from the business area level to the service corporate level at the beginning of each fiscal year. As a result, the financial statements at the business area level do not contain cumulative cash balances.

Fund Balance With Treasury was adjusted for the amount of undistributed disbursements and collections reported in the departmental expenditure system. These transactions represent in-float (undistributed) transactions that have not been recorded by the charged funded station in the same month the disbursement was processed.

G. Accounts Receivable

Accounts Receivable is adjusted for the amount of undistributed collections reported in the departmental expenditure system. These transactions represent in-float (undistributed) transactions that have not been recorded by the charged funded station in the same month the disbursement was processed. Accounts Receivable also includes the account Refunds Receivable.

Footnotes

H. Inventories

DoD designates inventory as the aggregate of tangible personal property items categorized as either consumable or depot level repairable items. Inventory items are either 1) held for sale to DoD users (or to other authorized customers, including U.S. allies) in the ordinary course of Defense operations, 2) in the process of repair or production for resale, 3) to be currently consumed directly or indirectly in the production of goods or services for sale, or 4) held for future use. Inventories are carried at standard prices (established by Army or Defense Logistics Agency) throughout the year, as required by DoD accounting directives.

I. Property, Plant, and Equipment

The General Accounting Office (GAO) has determined that real property used by the DBOF, but under jurisdiction of the Military Departments, represents an asset of the DBOF. To show the full costs of all resources and assets used in DBOF operations, the value of such property is reported on the financial statements as part of entity property, plant, and equipment.

Losses are recognized in the Statement of Operations for the loss of equipment. Depreciation for revolving fund property and equipment is calculated using the straight line method. Routine maintenance and repair costs are expensed when incurred.

J. Prepaid and Deferred Charges

Payments in advance of the receipt of goods and services are recorded as prepaid charges (advances) at the time of prepayment. They are recognized as expenditures/expenses when the related goods and services are received.

K. Annual, Sick, and Other Leave

Civilian annual leave is accrued as earned and the accrued amounts are reduced as leave is taken. The balances for annual leave at the end of the fiscal year reflect current pay rates for the leave that is earned but not taken. Sick and other types of nonvested leave are expensed as taken. Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates.

L. Accounts Payable

Accounts payable for goods and services are recognized based upon receipt of a receiving report providing notification of acceptance of goods or services. Fiscal stations may record obligations, accruals, and expenses simultaneously when preparing obligation documents for

travel, transportation, or for documents with small amounts (i.e., $1,000 or less). These actions assume that receipt will take place within 30 days of obligation.

Accounts Payable is adjusted for the amount of undistributed disbursements reported in the departmental expenditure system. These transactions represent in-float (undistributed) disbursements for transactions that have not been recorded by the charged funded station in the same month the disbursement was processed.

M. Accrued Payroll and Benefits

All civilian payroll earned but not paid is accrued in the financial statements as a non-federal liability.

N. Deferred Revenue

Unearned revenue recorded as other liabilities represent payments received in advance of the delivery of goods or services. This action did not change customer order acceptance procedures, the obligation of customer funds or the scheduled accomplishment of the orders.

Footnotes

Note 2. Fund Balance with Treasury

B. Defense Business Operations Fund Activities Below USD(C) Level

	Entity Assets	
	Funds Collected	Funds Disbursed
Beginning Balance	$ 7,146,350	
Transfers of Cash to Others		$ 9,630,275
Transfers of Cash from Others	8,072,098	
Funds Collected	68,458,440	
Funds Disbursed		69,644,947
Total	$ 83,676,888	$ 79,275,222

C. Business Operations Fund Activities and All Other Funds and Accounts

	Non-Entity Assets	
	Funds Collected	Funds Disbursed
Beginning Balance	$ 149,712	$ 131,422
Funds Collected	25,186	
Funds Disbursed		21,539
Ending Balance	$ 174,898	$ 152,961

D. Other Information: Non-entity assets represents amounts included in temporary suspense which are forwarded to non-DBOF recipients.

Note 3. Cash, Foreign Currency and Other Monetary Assets

	Entity Assets	Non-Entity Assets
A. Cash	$ 1	
B. Foreign Currency		
C. Other Monetary Assets		
D. Total Cash, Foreign Currency and Other Monetary Assets	$ 1	$ -0-

Note 4. Investments (Not applicable.)

Footnotes

Note 5. Accounts Receivable

	Gross Amount Due	Allowance For Estimated Uncollectibles	Allowance Method Used	Net Amount Due
A. Entity Receivables				
Intragovernmental, Net	$ 5,177,165	$ 11,597	See Item C	$ 5,165,568
Governmental, Net	2,212,621	5,764	See Item C	2,206,857
B. Non Entity Receivables				
Intragovernmental, Net	$ -0-	$ -0-		$ -0-
Governmental, Net	-0-	-0-		-0-

C. Other Information: Method of calculating the allowance varies for each department and agency.

Note 6. Other Federal (Intragovernmental) and Non-Federal (Governmental) Assets

A. Other Entity Assets	
1. Federal (Intragovernmental)	
a. Advances to US Printing Office	$ 2
b. Supply Management	858,338
c. Other	96,097
Total	$ 954,437
2. Non-Federal (Governmental)	$ -0-
B. Other Non-Entity Assets	
1. Federal (Intragovernmental)	
a. IMRL Equipment	$ 375,620
2. Non-Federal (Governmental)	$ -0-

C. Other Information: The $375,620 in Note 6.C.1(a) reports the FY 1996 gross value of Individual Material Readiness List (IMRL) equipment as requested by the ASN(FM&C). The NAVAUDSVC Audit report 044-95 has questioned the inclusion of IMRL in this section of the statement of Financial Position. Recommendation 83 recommended USD(C) prepare and issue clarifying guidance in the area of sponsor provided assets and Non-Entity Assets. Pending USD(C) guidance, DON will continue to report IMRL as Non-Entity Assets at the departmental level only as agreed to in a joint meeting among NAVAUDSVC, DFAS Headquarters, DFAS-Cleveland and DON on 21 July 1995.

Note 7. Loans and Loan Guarantees, Non-Federal Borrowers (Not applicable.)

Footnotes

Note 8. Inventory, Net

	Inventory Amount	Allowance for Losses	Inventory Net	Valuation Method
A. Inventory Categories:				
1. Held for Current Sale	$ 50,808,834	$ 7,071,256	$ 43,737,578	See Item B.
2. Held in Reserve For Future Sale	345,988		345,988	
3. War Reserve Materiel	3,621,884		3,621,884	
4. Excess, Obsolete and Unserviceable	14,517,968	11,646,875	2,871,093	
5. Held for Repair	12,087,484	2,354,878	9,732,606	
Total	$ 81,382,158	$ 21,073,009	$ 60,309,149	

B. Other Information: Method of valuing inventory varies for each department and agency. Inventory values presented are generally a combination of latest acquisition cost and standard price as set by service inventory control point. Excess, obsolete and unserviceable inventory has generally been revalued to its net realizable value.

Note 9. Work in Process

	Work In Process Amount	Valuation Method
A. Work in Process:		
1. In House	$ 1,987,978	See Item B.
2. Contractor	488,391	
3. Other Government Activities	26,382	
4. Government Furnished Materials	23,526	
Total	$ 2,526,277	

B. Other Information: Work In Process represents labor, material and overhead cost incurred during the period but not recognized as revenue. Valuation methods vary between the services but include actual costs and weighted average methods of determination.

Note 10. Operating Materials and Supplies (OM&S), Net

	OM&S Amount	Allowance for Losses	OM&S, Net	Valuation Method
A. OM&S Categories:				
1. Held for Use	$ 1,486,764	$ 10,898	$ 1,475,866	See Item B.
2. Held in Reserve for Future Use	34,265		34,265	See Item B.
3. Excess, Obsolete & Unserviceable	26,529		26,529	See Item B.
Total	$ 1,547,558	$ 10,898	$ 1,536,660	

B. Other Information: Valuation method varies with reporting service. Data presented is a combination of latest acquisition cost, weighted average and standard price as set by the service inventory control point.

Note 11. Stockpile Materials (Not applicable.)

Note 12. Seized Property (Not applicable.)

Note 13. Forfeited Property, Net (Not applicable.)

Note 14. Goods Held Under Price Support and Stabilization Programs, Net (Not applicable.)

Footnotes

Note 15. Property, Plant, and Equipment, Net

Classes of Fixed Assets	Depreciation Method*	Service Life*	Net Acquisition Values	Accumulated Depr.	Net Book Value
A. Land			$ 141,560		$ 141,560
B. Structure, Facilities, and Leasehold Improvements	SL	11-20	11,723,327	$ 6,085,077	5,638,250
C. Military Equipment	SL	6-10	2,348,026	1,214,535	1,133,491
D. ADP Software	SL	1-5	1,008,926	547,582	461,344
E. Equipment	SL	6-10	7,511,875	4,892,419	2,619,456
F. Assets Under Capital Lease	SL	6-10	9,243	3,453	5,790
G. Other	SL	6-10	45,096	26,239	18,857
H. Natural Resources			318,350		318,350
I. Construction-in-Progress			1,930,852	2,065	1,928,787
Total			$ 25,037,255	$ 12,771,370	$ 12,265,885

J. Other Information: Depreciation method within DoD is consistently straight line; however, service life varies slightly by reporting service/agency. Service life shown represents the most commonly used life.

* Keys:

Depreciation Methods
SL - Straight Line
DD - Double-Declining Balance
SY - Sum of the Years Digits
IN - Interest (sinking fund)
PR - Production (activity or use method)
OT - Other

Range of Service Life
1-5 - 1 to 5 Years
6-10 - 5 to 10 Years
11-20 - 11 to 20 Years
>20 - Over 20 Years

28

Footnotes

Note 16. Debt

Liabilities Covered By Budgetary Resources	Beginning Balance	New Borrowings	Repay-ments	Ending Balance	Re-financing
A. Intragovernmental Debt:					
1. Borrowing from the Treasury					
2. Borrowing from Federal Financing Bank	$ 1,432,108		$ 49,345	$ 1,382,763	
3. Borrowing from Other Federal Agencies					
Total Intragovernmental Debt	$1,432,108	$ -0-	$ 49,345	$ 1,382,763	$ -0-
Liabilities Not Covered by Budgetary Resources					
B. 1. Public Debt:					
a. Held by Government Accounts					
b. Held by Public					
c. Total Public Debt					
2. Agency Debt:					
a. Held by Government Accounts					
b. Held by Public					
c. Total Agency Debt					
C. Total Liabilities For Debt Not Covered by Budgetary Resources	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-
D. Total Debt	$1,432,108	$ -0-	$ 49,345	$ 1,382,763	$ -0-

E. Other Information: Balance remaining is the principle balance left on a program which provides ships for time charter to the Military Sealift Command to meet requirements not available in the marketplace. Additional information on these loans can be found in the financial statements for the Navy Transportation-Military Sealift Command and the U.S. Transportation Command.

Footnotes

Note 17. Other Liabilities

A. Other Liabilities Covered by Budgetary Resources:

	Non-Current Liabilities	Current Liabilities	Total
1. Intragovernmental			
a. Unearned Revenue, Advances From Gov't and Funds	$ 66,449	$ 1,604,080	$ 1,670,529
b. Unearned Revenue, Intra-DoD		784,624	784,624
c. Contingent Liabilities		98,640	98,640
d. Liability for Property Furnished by Others		588,138	588,138
e. Progress Billings to Others		609,449	609,449
f. Reserve for Equity for Others		161,132	161,132
g. Suspense Account		21,937	21,937
h. Miscellaneous Other Liabilities	1,407,609	204,215	1,611,824
Total	$ 1,474,058	$ 4,072,215	$ 5,546,273
2. Governmental			
a. Contract Holdbacks		$ 15,719	$15,719
b. Unearned Revenue, Advances From Public		105,368	105,368
c. Deferred Credits	$ 64,124	1,795	65,919
d. Accrued Expenses-Other		2,952,380	2,952,380
e. Other	82	364,572	364,654
Total	$ 64,206	$ 3,439,834	$ 3,504,040

B. Other Liabilities Not Covered by Budgetary Resources:

1. Intragovernmental			
Total	$ -0-	$ -0-	$ -0-
2. Governmental			
a. Canceled Budget Authority			
b. Acquired Leave Liability		$ 86,985	$ 86,985
Total	$ -0-	$ 86,985	$ 86,985

Note 18. Leases

A. ENTITY AS LESSEE

Capital Leases

Summary of Assets Under Capital Lease:

Land and Buildings	$ -0-
Machinery and Equipment	3,281
Other	2,746
Accumulated Amortization	2,405

Description of Lease Arrangements: Data processing equipment and software depreciated over a period of 3 to 5 years at various Defense Megacenters.

Future Payments Due

	Asset Category			
Fiscal Year	(1)	(2)	(3)	Totals
Year 1		$ 1,084	528	$ 1,612
Year 2		596	538	1,134
Year 3		165	347	512
Year 4		151	33	184
Year 5		151	29	180
After Year 5				
Total Future Lease Payments		$ 2,147	$ 1,475	$ 3,622
Less: Imputed Interest				
Executory Costs				
Total Capital Lease Liability	$ -0-	$ 2,147	$ 1,475	$ 3,622

Operating Leases

Description of Lease Arrangements: Defense Information Systems Agency (DISA) Denver office building lease contract 1994-1999.

Future Payments Due

	Asset Category			
Fiscal Year	(1)	(2)	(3)	Totals
Year 1	$ 472			$ 472
Year 2	472			472
Year 3				
Year 4				
Year 5				
After Year 5				
Total Future Lease Payments	$ 944	$ -0-	$ -0-	$ 944

31

Footnotes

Note 19. Pensions and Other Actuarial Liabilities

Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (7%)	Assets Available to Pay Benefits	Unfunded Actuarial Liability
A. Pension and Health Plans	$ 33		$ 33	
B. Insurance/Annuity Programs:				
C. Other:				
1. Workman's Compensation	48,886			$ 48,886
D. Total	$ 48,919		$ 33	$ 48,886

Note 20. Net Position

	Revolving Funds	Trust Funds	Appro-priated Funds	Total
A. Unexpended Appropriations:				
1. Unobligated,				
a. Available	$ 1,493,290			$ 1,493,290
b. Unavailable	(225,439)			(225,439)
2. Undelivered Orders	56,442			56,442
B. Invested Capital	113,173,469			113,173,469
C. Cumulative Results of Operations	(33,826,228)			(33,826,228)
D. Other	(6,677,115)			(6,677,115)
E. Future Funding Requirements	(135,871)			(135,871)
F. Total	$ 73,858,548	$ -0-	$ -0-	$ 73,858,548

G. Other Information: Appropriations unavailable represents balances picked up during the original capitalization of the Army Industrial Fund. This amount was transferred forward with the creation of DBOF.

Note 21. Taxes (Not applicable.)

Footnotes

Note 22. Other Revenues and Financing Sources

	1996	1995
Other Revenues and Financing Sources:		
1. Other Miscellaneous Gains	$ 48,777	$ 214,641
2. Miscellaneous Reimbursements	70,501	251,600
3. Claims	42,113	(34,289)
4. Invested Capital	724	724
5. Recoveries from Transportation and Port Handling	6	929
6. Other Revenue	170,450	199,565
7. Supply	146,426	214,994
8. Base Support	22	26
9. Maintenance	18,965	9,245
Total	$ 497,984	$ 857,435

Note 23. Program or Operating Expenses

	1996	1995
A. Operating Expenses by Object Classification:		
1. Personal Services and Benefits	$ 2,947,803	$ 2,457,591
2. Travel and Transportation	1,378,985	1,223,847
3. Rental, Communication and Utilities	97,408	122,263
4. Printing and Reproduction	27,073	26,586
5. Contractual Services	5,330,372	3,155,608
6. Supplies and Materials	175,010	158,697
7. Equipment not Capitalized	136,606	155,818
8. Grants, Subsidies and Contributions	2,133	964
9. Insurance Claims and Indemnities	25,835	14,153
10. Other (describe)		
a. Interest	679	1
b. Other	1,688,690	465,940
11. Total Expenses by Object Class	$ 11,810,594	$ 7,781,468

Footnotes

Note 24. Cost of Goods and Services Sold

A. Cost of Services Sold	
1. Beginning Work-in-Process	$ 2,680,960
2. Plus: Operating Expenses	30,537,506
3. Minus: Ending Work-in-Process	2,526,277
4. Minus: Completed Work for Activity Retention	21,445
Cost of Services Sold	$ 30,670,744
B. Cost of Material Sold from Inventory	
1. Beginning Inventory - L.A.C.	$ 70,832,142
2. Less: Beginning Allowance for Unrealized Holding Gains (Losses)	9,836,989
3. Plus: Purchases at Cost	29,409,343
4. Plus: Customer Returns - Credit Given	3,962,549
5. Plus: DLR Exchange Credits	3,269,423
6. Less: Inventory Losses Realized	3,019,826
7. Less: Ending Inventory - L.A.C.	81,378,904
8. Plus: Ending Allowance for Unrealized Holding Gains (Losses)	21,073,010
9. Less: Equity Transfers of Inventory to Others	274,069
10. Plus: Equity Transfers of Inventory from Others	1,174,256
Equals Cost of Goods Sold from Inventory.	$ 35,210,935
C. Intra eliminations	5,079,662
D. Total	$ 60,802,017

E. Other Information: All expense eliminations were applied against cost of goods sold.

34

Note 25. Other Expenses

	1996	1995
A. Other Expenses		
1. Transfers to Property and Disposal	$ 9,995,780	$ 4,298,363
2. Potential Excess Inventory Loss	(331,655)	822,952
3. Operating Materials and Supplies Variance	3,059	
4. Shrinkage, Fire, Theft, Losses, etc.	63,047	135,548
5. Payroll Variances	4,171	
6. Accrued Annual Leave	384	(5,599)
7. Real Property Maintenance		954
8. Losses on Sale of Fixed Assets	6,307	1,388
9. Sum of USD(C) Model Entries	(3,868,016)	
10. Unfunded Depreciation Expense		23,941
11. Prior Year Expense Adjustment	(2,113)	
12. Supply	(2,814,889)	3,704,265
13. Base Operations		323
14. Depot Maintenance	45,837	92,778
15. Other Miscellaneous Losses	(190,808)	(730,124)
Total Other Expenses	$ 2,911,104	$ 8,344,789

Note 26. Extraordinary Items

A. Extraordinary Items:	
1. Inventory Losses from Fire and Theft	($ 13,664)
2. Surcharges	(112,262)
3. Extraordinary Current Year Expense	(2,703)
4. Passthroughs	593,917
5. Military Labor Variance	(1,751)
6. Reserve Balancing	303
7. Fixed Asset Adjustment	46
8. Litigation over Sale of Ships	(2,500)
9. Depot Maintenance	(33,127)
Total	$428,259

Footnotes

Note 27. Prior Period Adjustments

A. Prior Period Adjustments:	
1. Write-off of Prior Year Accounts Receivable and Accounts Payable	$ 75,996
2. Prior Year Depreciation	114,013
3. Duplicate Entries	(12,366)
4. Reconcile control to Subsidiary	(18,871)
5. Prior Year Expense	(692)
6. Inventory Gain/Loss Adjustment	(1,351,129)
7. Prior Year Revenues	548,071
8. Adjustment to Capitalized Assets	(82,340)
9. Prior Year Unfunded	(66,811)
10. Fuels - Congressional Mandated Refund	(137,600)
11. JLSC Transfer	(46,720)
12. Subsistence Transportation	(19,511)
13. Depot Maintenance	(26,959)
14. Transportation	(9,771)
15. Supply Management	(4,642,828)
16. Other	51,640
Total	($ 5,625,878)

Note 28. Non-Operating Changes - (Transfers and Donations)

	1996	1995
A. Increases		
1. Transfers-In:		
a. Cash	$ 2,183,255	$4,005,573
b. Property	226,448	313,683
c. Transfer Without Reimbursement - DBOF	759,014	27,797,558
2. Unexpended Appropriations		10,853
3. Donations Received:	35,136	566,669
4. Other Increases:	6,681,485	3,137,010
5. Total Increases:	$ 9,885,338	$ 35,831,346
B. Decreases		
1. Transfers-Out:		
a. Cash	$ 2,154,365	$ 874,736
b. Property	1,707,040	31,671,218
2. Donations		58,802
3. Other Decreases:	1,218,303	6,848,651
4. Total Decreases:	$ 5,079,708	$ 39,453,407
C. Net Non Operating Changes (Transfers)	$ 4,805,630	($3,622,061)

36

Footnotes

Note 29. Intrafund Eliminations

Schedule A (Not applicable.)

Schedule B (Not applicable.)

Schedule C

Selling Activity:	Accounts Receivable	Revenue	Unearned Revenue	Collections
Army - DBOF	$ 248,864	$ 2,597,023	n/a	$ 2,618,709
Navy - DBOF		122,104	n/a	122,104
Air Force - DBOF	16,162	56,862	n/a	
DLA - DBOF			n/a	
DISA - DBOF			n/a	
DFAS - DBOF			n/a	
JLSC - DBOF			n/a	
DeCA -DBOF			n/a	
U.S. TRANSCOM	53,063	30,558	n/a	
Other			n/a	
Total	$ 318,089	$ 2,806,547	n/a	$ 2,740,813

Customer Activity:	Accounts Payable	Expenses	Advances	Disbursements
Army - DBOF	$ 211,082	$ 2,283,481	n/a	$ 2,297,145
Navy - DBOF	21,234	62,296	n/a	60,039
Air Force - DBOF	35,522	332,251	n/a	256,626
DLA - DBOF	5,785	68,777	n/a	69,365
DISA - DBOF	1,245	5,670	n/a	4,627
DFAS - DBOF	1,399	15,274	n/a	14,104
DeCA -DBOF	1,850	3,586	n/a	1,833
JLSC - DBOF	31	344	n/a	313
U.S. TRANSCOM	2,063	92,305	n/a	1,123
Other	37,878	(57,437)	n/a	35,638
Total	$ 318,089	$ 2,806,547	n/a	$ 2,740,813

Footnotes

Schedule D

Selling Activity:	Accounts Receivable	Revenue	Unearned Revenue	Collections
DBOF	$ 410,799	$ 33,484,192		$ 23,854,399
Unearned Revenue			$ 190,650	
Total	$ 410,799	$ 33,484,192	$ 190,650	$ 23,854,399

Customer Activity:	Accounts Payable	Expenses	Advances	Disbursements
Department of the Army	$ 114,357	$ 6,077,304	n/a	$ 5,952,171
Department of the Navy	20,616	15,792,050	n/a	15,649,002
Department of the Air Force	233,085	8,492,875	n/a	427,725
Defense Business Operations Fund			n/a	
DoD Military Retirement Trust Fund			n/a	
National Defense Stockpile			n/a	
U.S. Army Corps of Engineers			n/a	
Other Defense Organizations	42,741	3,121,963	n/a	1,825,501
Advances			$ 190,650	
Total	$ 410,799	$ 33,484,192	$ 190,650	$ 23,854,399

Schedule E

Selling Activity:	Accounts Receivable	Revenue	Unearned Revenue	Collections
DBOF	$ 76,942	$ 1,232,455		$ 562,235
Unearned Revenue				
Total	$ 76,942	$ 1,232,455	$ -0-	$ 562,235

Customer Activity:	Accounts Payable	Expenses	Advances	Disbursements
General Services Administration	$ 6,572	$ 197,873	n/a	$ 193,155
Agriculture	127	99	n/a	185
Interior	1,450	1,924	n/a	477
NASA	12,637	38,941	n/a	199
State	22	50	n/a	40
Transportation	449	2,337	n/a	3,722
Treasury	113	958	n/a	1,488
Veterans Affairs	16	93	n/a	99
Justice	180	106	n/a	58
Federal Emergency Management	1,694	145	n/a	141
Defense Security Assistance Agency		328,097	n/a	328,097
Other	53,682	661,832	n/a	34,574
Advances				
Total	$ 76,942	$ 1,232,455	$ -0-	$ 562,235

Note 30. Contingencies (Not applicable.)

Note 31. Other Disclosures

Problem Disbursements:

DBOF (T.I. 97) Appropriations	1995	1996	Change	Percentage Change
Unmatched Disbursements	$ 1,912,037	$ 815,076	$ 1,096,961	57.37%
Negative Unliquidated Obligations	123,969	52,226	71,743	57.87%

The data shown on this chart is a consolidation of data as reported by the individual services and agencies. Some entities reported no data for FY 1995 or data in only one category. As a result, the figures reported for FY 1995 are probably low. The actual decrease from FY 1995 to FY 1996 is probably greater than depicted.

Footnotes

Net Position:

The reported Navy DBOF Supply Management Net Position is calculated using a USD(C)/DFAS-HQ model. Several invested capital accounts that were once considered Transfers-in and Transfers-out were crossed to allowance accounts in the model and used in the Latest Acquisition Cost calculation. Cumulative Results of Operations, line 7C, is also calculated by the model. The total includes an adjustment of $444 million that is formula driven keeping a journal voucher entry in balance. In addition, because of methodology changes imposed by the model line 7C (FY 1996) does not equal Line 7C of prior year on the Statement of Financial Position plus current year net operating results, Line 16, plus current year adjustments, Line 20 of the Statement of Operations and changes in Net Position. Net Position, Beginning Balance, as previously stated, Line 19 does not equal the ending position of FY 1995. This is a result of changes in methodology as contained in the model.

Restatement of Prior Year Principal Statements:

The fiscal year 1995 DBOF Principal Statements have been restated in the following areas:

Statement of Financial Position

	FY 1995	FY 1995 Restated	Difference
Line 1.d., Inventory	$55,260,195	$59,887,675	$4,627,480
Line 1.g., Stockpile Materials	$ 4,780,335	$ 152,855	($4,627,480)

The revised OSD Form and Content guidance required War Reserves material to be reclassified as inventory. The reclassification was done for all Supply Management business areas with the exception of the Navy.

Statement of Cash Flows

	FY 1995	FY 1995 Restated	Difference
Line 20, Appropriations	$ 177,732	$1,117,870	$ 940,138
Line 22.b., Transfers of Cash from Others	$4,826,102	$3,885,964	($ 940,138)

Footnotes

A Department of Defense, Inspector General (DoDIG) audit report titled, "Appropriated Capital Used in the FY 1995 DBOF Financial Statements," noted that the FY 1995 DeCA financial statements required corrections. Specifically, $940 million was reported as a non-expenditure transfer instead of as a financing source. An adjustment was made to the FY 1995 financial statements, which restated this amount as Appropriations.

In addition to these reclassifications, there were some other reclassifications made at the DoD Component or business area level which are not reflected on the Principal Statements. These reclassifications in most cases are identified in the individual business area financial statements and the differences are identified in the DoD Component or business area notes to the financial statements.

Footnotes _____

Defense Business Operations Fund Major Defense Departments
Combining Statements*

*Omitted because of length

DEFENSE BUSINESS OPERATIONS FUND

AUDIT OPINION

87

Audit Opinion _____

88

Audit Opinion

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

May 5, 1997

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

SUBJECT: Disclaimer of Opinion on the Defense Business Operations Fund Financial Statements for FY 1996 (Project No. 5FH-2015)

The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibilities of management and the auditors with respect to the financial statements, internal controls, and compliance with laws and regulations. Fund managers are responsible for establishing and maintaining an internal control structure and for complying with laws and regulations applicable to the Defense Business Operations Fund (DBOF). Our responsibility is to express an opinion on the financial statements based on our audit, to determine whether internal controls are adequate, and to determine whether the DBOF complies with applicable laws and regulations.

Disclaimer of Opinion. We were unable to render an opinion on the DBOF Consolidated Financial Statements for FY 1996. Significant deficiencies in the accounting systems and the lack of a sound internal control structure prevented the preparation of accurate financial statements. Without a sound internal control structure, the financial information provided to management for the financial statements and for directing DBOF operations cannot be relied on for making decisions or assessing performance. However, we were able to evaluate some internal controls and aspects of compliance with laws and regulations. The following paragraphs summarize the major internal control and compliance weaknesses facing the DBOF.

Internal Controls. Internal controls for the DBOF are not adequate. Specifically, internal controls associated with accounting systems do not provide reasonable assurance that financial information is reliable. The systems do not allow for consistency in financial reporting or comparability of information on DBOF operations. Additionally, the U.S. Government Standard General Ledger (USGSGL) accounts have not been fully implemented. When preparing the financial statements, DBOF activities continue to use unique charts of accounts for operational purposes and then crosswalk the accounts from each activity's general ledger to the USGSGL, significantly increasing the potential for error.

We also noted significant control weaknesses in the preparation of adjusting entries at the DFAS Denver Center. A total of 125 adjusting entries amounting to over $227 billion were made to the Air Force portion of the DBOF financial statements as of April 23, 1997. No support was provided for 115 of those adjustments, valued at $226.8 billion.

We observed some improvements in financial reporting as a result of corrective actions taken by management at lower-level DBOF activities. However, these changes have not significantly improved the DBOF internal control structure or the overall reporting of financial information at the consolidated statement level. Additionally,

Audit Opinion

DoD has developed an interim migratory system strategy to accelerate the consolidation of DBOF accounting systems. When the migratory systems become functional, accountability and reporting capabilities should improve. However, the interim migratory systems strategy has not been finalized, and the total costs and time frames for implementation are unknown.

Compliance With Laws and Regulations. Instances of noncompliance with regulations continue to exist within the DBOF. Accounting systems do not completely or accurately disclose the financial position of the DBOF activities as required by title 31, United States Code. Most of the numerous DBOF financial systems do not meet the requirements of Office of Management and Budget (OMB) Circular No. A-127, "Financial Management Systems," July 23, 1993. OMB Circular No. A-127 states that accounting systems must be integrated and must meet other requirements for documentation, audit trails, and general ledger control. DBOF activities do not always comply with DoD 7000.14-R, the "DoD Financial Management Regulation," in areas such as the Standard General Ledger; Property, Plant, and Equipment; Expenses: and Revenue Recognition.

In addition, management is not in compliance with the Federal Financial Management Act of 1994, which requires agencies to submit their audited financial statements to OMB by March 1, 1997. We were unable to provide an audit opinion on the financial statements by March 1, 1997, because we did not receive the financial statements in sufficient time to complete our audit work by the deadline.

Other Matters of Interest. In December 1996, the Under Secretary of Defense (Comptroller) announced that the DBOF would be separated into several Working Capital Funds. This realignment does not affect the matters discussed in this opinion memorandum.

Additional Reports. This memorandum briefly summarizes the major deficiencies affecting the DBOF. We plan to issue reports with further details on internal controls and compliance with laws and regulations. We will also issue a report detailing the major accounting and internal control deficiencies that affect the DBOF.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Appendix D. Laws and Regulations Reviewed

Subtitle II, The Budget Process, Title 31, United States Code, including the Antideficiency Act provisions of Title 31, United States Code; Section 1341 (31 U.S.C. 1341), "Limitations on Expending and Obligating Amounts"; and 31 U.S.C 1517, "Prohibited Obligations and Expenditures"

Subtitle III, Financial Management, Title 31, United States Code, including the requirements for accounting and accounting systems and information in 31 U.S.C. 3511, 3512, 3513, and 3514 and the financial statement requirements in 31 U.S.C. 3515

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 100-496, "Prompt Payment Act of 1988," October 17, 1988

Public Law 97-365, "Debt Collection Act," October 25, 1982

Historical and Statutory Notes to 10 U.S.C. 2208, Working-Capital Funds

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 1, "General Financial Management Information, Systems, and Requirements," May 1993

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 4, "Accounting Policy and Procedures," January 1995

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 5, "Disbursing Policy and Procedures," December 1993

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 8, "Civilian Pay Policies and Procedures," March 1993

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 11B, "Reimbursable Operations Policy and Procedures--Defense Business Operations Fund," December 1994

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," Volume 14, "Administrative Control of Funds and Anti-Deficiency Violations," August 1995

DoD Regulation 7000.14-R,. "DoD Financial Management Regulation," Volume 15, "Security Assistance Policy and Procedures," March 1993

DoD Manual 7220.9-M, "DoD Accounting Manual," as revised June 17, 1991

DoD Directive 7200.1, "Administrative Control of Appropriations," as revised July 27, 1987

DoD Directive 5010.381,[1] "Internal Management Control Program," April 14, 1987

"DoD Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity," October 20, 1994

Joint Financial Management Improvement Program Core Financial System Requirements FFMSR-1,[2] as revised April 1994

Treasury Financial Manual, June 12, 1990

GAO "Policy and Procedures Manual for Guidance of Federal Agencies," Title 2, "Accounting," May 18, 1988

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

OMB Bulletin No. 93-02, "Form and Content of Agency Financial Statements," October 22, 1992

OMB Circular No. A-127, "Financial Management Systems," as revised July 23, 1993

OMB Circular No. A-123, "Internal Control Systems," August 4, 1986

OMB Statement of Federal Financial Accounting Standards Number 1, "Accounting for Selected Assets and Liabilities," March 30, 1993

OMB Statement of Federal Financial Accounting Standards Number 2, "Accounting for Direct Loans and Loan Guarantees," August 23, 1993

OMB Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property," October 27, 1993

OMB Statement of Federal Financial Accounting Standards Number 4, "Managerial Cost Accounting Concepts and Standards," July 31, 1995

OMB Statement of Federal Financial Accounting Standards Number 5, "Accounting for Liabilities of the Federal Government," September 1995

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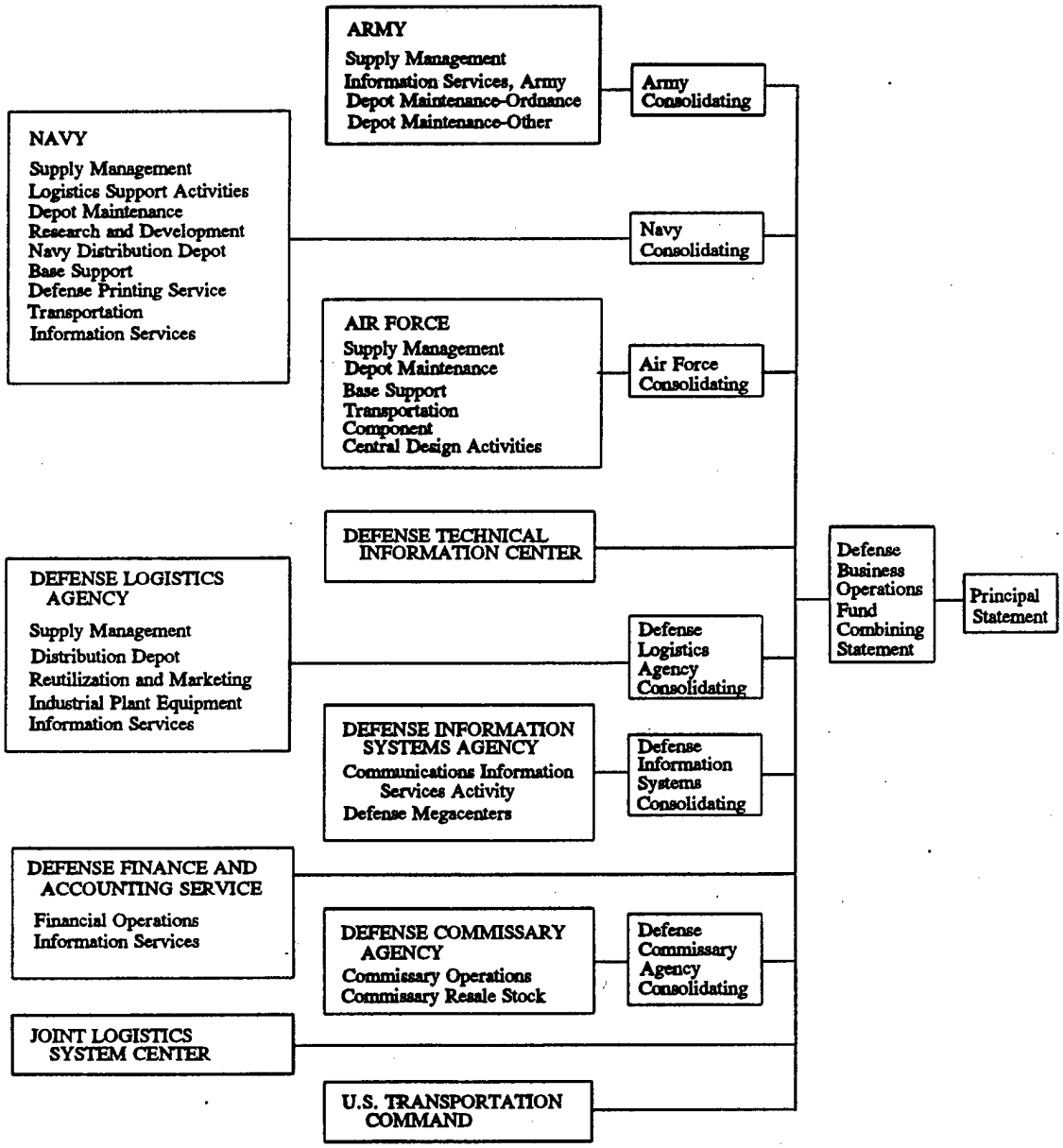
[1]DoD Directive 5010.38 has been revised as "Management Control Program," August 26, 1996. The audit was performed under the April 1987 version of the directive.

[2]Federal Financial Management System Requirements.

OMB Statement of Federal Financial Accounting Concepts Number 1, "Objectives of Federal Financial Reporting," September 2, 1993

OMB Statement of Federal Financial Accounting Concepts Number 2, "Entity and Display," June 6, 1995

Appendix E. Financial Statement Reporting Structure for the Defense Business Operations Fund



Appendix F. Management Representation Letter

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

APR _9 1997

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Management Representation Letter for the Defense Business Operations Fund Financial Statements for FY 1996

Reference is made to the FY 1996 Principal Financial Statements for the Defense Business Operations Fund (Project No. 5FH-2015). For the purpose of expressing an opinion on whether those statements are presented fairly and in accordance with generally accepted accounting principles and Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, I confirm, to the best of my knowledge and belief, the following representations:

- I am responsible for the fair presentation of the Defense Business Operations Fund financial statements in accordance with OMB Bulletin 94-01.

- To the best of my knowledge, all financial records and related data have been made available to you.

- I understand that we have prepared the carrying value or classification of assets and liabilities in a manner that conforms to our published policies and I have no plans or intentions to change it.

- I know of no irregularities involving management personnel or employees who have significant roles in the internal control structure that are not a matter of public record.

- I know of no other employees being involved in irregularities that could materially affect the financial statements that are not a matter of public record.

- I know of no communications from regulatory agencies or auditors concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements that are not a matter of public record.

- We do not consider related third-party transactions and related amounts receivable or payable of interested participants, including assessments, loans, and guarantees as applicable and make no assurance in that regard.

- I know of no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements, or, as a basis for recording a loss contingency, that are not a matter of public record.

- I know of no material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies," March 1975.

- I know of no unasserted claims or assessments that our legal representatives have advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board Statement No. 5, beyond those that may be reported in the legal representation letter for the Defense Business Operations Fund that will be furnished shortly to you by the General Counsel of the Department of Defense.

- I have no knowledge of material transactions that have not been properly recorded in the accounting records underlying the financial statements that are not a matter of public record.

- The offices responsible for the stewardship of equipment and stockage inventories have made plans to reduce excess or obsolete inventories. The department has attempted to estimate this inventory value consistent with established guidelines for net realizable value.

- To my knowledge and based on the management representation letters of subordinate offices, the Federal Government has satisfactory title to all reported assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral.

- I know of no plans to avoid compliance with any aspect of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

- I know of no events that have occurred after the balance sheet date that would require adjustment to or disclosure in the financial statements that have not been previously identified on the statements.

Attached are identified procedural and systemic deficiencies that may prevent an auditor from expressing an unqualified opinion on the financial statements.

My staff contact for this matter is Mr. Oscar G. Covell. He may be reached at e-mail: covello@ousdc.osd.mil or (703) 697-6149.

John J. Hamre

Attachment

DEFENSE BUSINESS OPERATIONS FUND (DBOF)
IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

Part 1. Departures from Published Accounting Policies and Procedures

Systemic and procedural deficiencies continued to exist in the Department's accounting and financial management systems during FY 1996. The following list summarizes known deficiencies within the accounting and financial management systems used to account for and report on financial activity for the Defense Business Operations Fund (DBOF).

A. General Ledger Control/Lack of Uniform Accounting Systems. The accounting systems in use by the Department do not provide consistency in financial reporting or comparability of information on operations for the DBOF. Integrated agency accounting and financial management systems are expected to provide for complete, reliable, consistent, and timely information that is prepared on a uniformed basis and responsive to the financial information needs of agency management. However, the Department must rely on existing accounting systems--systems that often are not integrated and provide DoD Component-unique information. Many of the DBOF activities are supported by unique computer programs used to summarize information for reporting to the DBOF. The summarized information must be collected from several DoD Component-unique sources, which results in a further lack of comparability for data received for the DBOF.

In general, DBOF activities do not have an effective reporting system that systematically summarizes financial information and, in some cases, documented procedures do not exist to determine which general ledger accounts were used to develop the various account classifications on the financial statements. Additionally, the U.S. Government Standard General Ledger (USGSGL) accounts have not been fully incorporated into the Defense Finance and Accounting Service (DFAS) accounting systems that support DBOF. Consequently, for the FY 1996 financial statements, preparers had to crosswalk general ledger accounts to the DoD uniform chart of accounts, then crosswalk the DoD accounts to the account classifications on the financial statements. In addition, integrated general ledger systems were not always available for use in producing the FY 1996 financial statements. Instead, reports from departmental budget and reporting systems sometimes were relied on to prepare financial reports. Similarly, some DBOF business areas were not supported by a fully integrated double-entry accounting system. In those instances, information was gathered from automated and manual systems to create a consolidated general ledger. Procedures used to create the general ledgers were not always fully documented, and procedures were not always in place to assure that all transactions were recorded. Automated accounting systems were not always in place to collect and report expenses as required, and the accounting systems did not always generate sufficient and suitable accounting data to permit the review and certification of fiscal year financial statements.

B. Integrated General Ledger. Not all of the Department's accounting systems use an integrated general ledger double-entry type system, from which financial statements can be produced. Not all accounting activities or reporting entities have controls in place to ensure that all valid transactions are properly recorded, processed, and summarized in order to always provide totally accurate financial information to fund managers. Rather than using the general ledger to account for major assets, most reporting entities frequently rely on information derived from operational and logistics systems. In addition, there is a lack of assurance that source data always is accurate

1

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DEFENSE BUSINESS OPERATIONS FUND (DBOF)
IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

because some discrepancies in the operational and logistics systems are not investigated in a timely manner. The absence of systems with fully integrated general ledger accounts, to capture all required financial information relative to DoD assets, limits the Department's capability to ascertain whether all assets are included in financial statement amounts. Consequently, there is no standard financial control over the amounts reported.

C. Standard General Ledger. The USGSGL has not been fully implemented for the DBOF business areas. During FY 1996, at least seven different general ledger structures were in use by DBOF activities. The USGSGL is intended to standardize federal accounting and meet the basic federal financial statement and budget execution reporting requirements. The DoD Components are using Component-unique charts of accounts and are crosswalking the financial data from the activities' general ledger accounts to the USGSGL for preparation of management reports and financial statements. The lack of a uniform general ledger within the DBOF increases the potential for accounting errors and increases the level of effort required to prepare and audit financial statements or management reports for the use of other government offices, such as the Treasury Department and the Office of Management and Budget (OMB). Since the crosswalks in use do not always have a one-for-one relationship to accounts in the USGSGL, transactions may not always be recorded and accounted for in a manner permitting the preparation of financial statements in strict accordance with OMB guidance.

In addition, the absence of standard general ledger accounting systems makes it difficult to ascertain whether like items are reported in similar general ledger balances. The Department has developed an interim migration strategy to consolidate DoD accounting systems. Once the interim migratory systems become functional, the Department expects to improve its accounting and reporting capabilities, and save resources, by using fewer systems and consolidating accounting functions. Interim migratory systems for the DBOF have been designated in the DoD Chief Financial Officer's Financial Management Status Report and 5-Year Plan for 1996-2000. These systems will be used in the future as the transition is made from many accounting systems to fewer, and more standard accounting systems that are transaction driven, integrated, and use the USGSGL.

D. Integrated Systems. The issue of integrating accounting systems with personnel, logistics, acquisition, and other systems has been a long-standing problem for the Department. The DFAS is evaluating the interface of systems and the sharing of data bases both within accounting and finance functional areas and with other functional areas such as personnel, logistics, and acquisition.

E. Inadequate Systems. In the preparation of the DBOF financial statements for FY 1996, some functional systems that feed data to the accounting systems were not reviewed adequately for conformance with applicable accounting requirements. Internal controls may have been inadequate in these feeder systems to ensure that items were inventoried or accounted for properly.

F. Inadequate Coding Structure. The coding structure within the accounting and financial management systems employed by DBOF activities has not been developed to adequately capture

DEFENSE BUSINESS OPERATIONS FUND (DBOF)
IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

and report all of the data necessary for preparing DBOF financial statements. For example, a coding structure does not exist to capture and report on interfund transactions within the DoD Components and primary and secondary areas within the DBOF.

Part 2. **Internal Controls**

A. Fund Balances With Treasury Not Reconciled. Unreconciled differences in disbursement and collection transactions resulted in accounting discrepancies between DBOF business area control accounts and installation level subsidiary accounting records.

B. Internal Controls. The internal controls governing the processes for preparing financial statements still are not adequate for significant portions of the adjustment and financial statement preparation processes.

C. Unmatched Disbursements. The auditors have reported that, contrary to policy, procedures do not ensure, necessarily, that disbursements always are posted to the correct obligation, or that possible duplicate payments are prevented.

D. Negative Unliquidated Obligations. Auditors have concluded that accounting offices, and the installations that they support, do not always effectively monitor or accurately report negative unliquidated obligation balances.

E. In-Transit Disbursements. The auditors have reported that, contrary to policy, procedures do not ensure, necessarily, that disbursements always are posted to the correct obligation on a timely basis.

F. Reporting of Plant, Property and Equipment. Although the auditors have noted some progress over prior years, overall procedures and controls may not be adequate to ensure that all plant, property and equipment are accurately reported in the Statement of Financial Position.

G. Adjustments to General Ledger Accounts. Adjusting entries sometimes may be made without required supporting documents. As a result, accounting adjustments or related account balances reported in the financial statements may not be substantiated. Some program managers may make incorrect or unsupported entries to year-end accounts on the financial statements because effective procedures for making adjusting entries have not yet been implemented or there are problems adhering to procedures that are in place.

H. Reconciliation of Property Records. Additional improvements were needed in accounting for equipment, and reconciling equipment values with subsidiary records.

I. Reconciliation of Subsidiary Records. Some required monthly reconciliations of disbursement and collection transactions in the disbursing system were not performed or only partially performed.

DEFENSE BUSINESS OPERATIONS FUND (DBOF)
IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

J. Accounting for Receivables and Payables. Accounts Receivable and Accounts Payable are not always recorded in the proper accounting period or reconciled to general ledger account balances. Weak internal controls may cause reimbursements to be collected but not posted or recorded; also, some funding documents were not received, which prevented the activities from billing customers.

K. Classification of Assets. Some equipment, inventories held for sale and inventories not held for sale may have been classified incorrectly.

L. Analytical Review of Account Balances. The reasonableness of amounts reported in the accounting records and financial statements was not always adequately reviewed.

M. Intrafund Eliminations. Auditors have found that the consolidated financial statements for the DBOF do not always include the required Intrafund Eliminations note to the financial statements. Those statements should include billions of dollars of transactions relating to collections and disbursements in the Intrafund Eliminations note.

N. Supporting Documentation. Adequate documentation to support the validity and accuracy of fund control transactions was not always obtained or maintained.

O. Liability Account Balances. Due to the inability to recoup credits given to retail customers who fail to return assets; as well as due to other system-wide processing problems, liability account balances in the DBOF consolidated financial statements may not be totally accurate.

P. In-Transit Accounts. The Department has, in the past, reported negative balances in an in-transit account. The auditors have concluded that the existence of a negative balance in an inventory account is inaccurate, and that one may not be able to rely on the systems that produced such figures.

Q. Valuation of Inventory. The auditors have reported that inventory was incorrectly valued. They also have stated that some maintenance activities valued all inventory at standard price, regardless of condition, which results in overvalued excess and unserviceable inventory.

R. Excess Material Valued Incorrectly. Excess material may be valued at latest acquisition cost vice the prescribed percent of latest acquisition cost.

S. Recording and Reporting of Equipment and Depreciation. The DBOF Component financial statements may not always disclose sponsor-funded property and equipment.

T. Accrual Accounting Procedures. General ledger and subsidiary accounts may not always be established as required and, in some cases, miscellaneous revenues either may not have been recorded when earned or not recorded at all. Reporting entities do not always promptly process all receipt information. Consequently, expenses frequently are not recorded prior to disbursements.

4

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DEFENSE BUSINESS OPERATIONS FUND (DBOF)
IDENTIFIED PROCEDURAL AND SYSTEMIC DEFICIENCIES

U. Audit Trails. Some reporting entities may not have established adequate audit trails to enable managers or auditors to verify disbursements. In some cases, due to inadequate system capabilities, payments posted to records may not be traceable to the records of the DoD Components that recorded the payments.

Part 3. Compliance

A. Interfacing of Accounting Systems. The OMB Circular A-127, "Financial Management Systems," requires that accounting systems interface with logistical systems and meet other requirements such as system documentation, audit trails, and general ledger control. The majority of the Department's financial management systems do not meet the requirements of the OMB Circular A-127. The auditors have in the past, concluded that many of the systems perform similar functions, which results in inefficiencies and disparate business practices.

B. Standard General Ledger. The DoD Financial Management Regulation, Volume 1, "General Financial Management Information, Systems and Requirements," requires that activities use the U.S. Government standard general ledger chart of accounts. The Under Secretary of Defense (Comptroller) (USD(C)) acknowledges that the standard general ledger has not been fully implemented in the DBOF business areas. Most of the noncompliant systems have a conversion program that crosswalks obsolete general ledger accounts or data bases to the standard general accounts.

C. Property, Plant, and Equipment. The DoD Financial Management Regulation requires that activities separately depreciate each building. However, existing accounting systems generally preclude determination of depreciation expense. For example, many activities do not have an accounting system that allows them to compute depreciation on separate buildings.

D. Inventory Valuation. The DoD policy requires that inventory be revalued to its latest acquisition cost at year end. This policy also requires that excess, obsolete, and unserviceable material be valued at its net realizable value. Maintenance activities sometimes value inventory at standard price, regardless of condition. This results in overvalued excess and unserviceable inventory. Some DBOF activities do not report excess inventories correctly because disposal of excess items could negatively affect operating results. In addition, local policies do not allow material to be excessed unless credit was received from the supply system.

E. Cash Reconciliation (Fund Balances With Treasury). Before FY 1995, the USD(C) was responsible for managing the Fund's cash. As of February 1, 1995, the USD(C) transferred responsibility for management of the Fund's cash to the cognizant DoD Components. Amounts reported as collected and disbursed on some DBOF financial statements do not agree with individual activities' records, even after cash reconciliations are performed. These amounts represent the value of collections and disbursements that were successfully processed through the Components' finance networks. Preparers of consolidated financial statements rely on information processed through the Army, Navy, and Air Force finance networks, while activities used additional information and omitted some information from those finance networks.

Appendix G. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Acquisition and Technology)
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Public Affairs)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy
Dudley Knox Library, Naval Postgraduate School

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

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D. Currently Applicable Classification Level: Unclassified

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