Independent Auditor's Report

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

November 12, 2007

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

SUBJECT: Independent Auditor's Report on the Department of Defense FY 2007 Financial Statements (Report No. D-2008-023)

We are providing the subject report to be published in the DoD FY 2007 Agency Financial Report in conjunction with the DoD Agency-Wide FY 2007 Basic Statements provided to us in draft on November 1, 2007. The report includes our disclaimer of opinion on the basic financial statements, as well as our required report on internal control and compliance with laws and regulations. Because our disclaimer of opinion is being issued to accompany the DoD Agency-Wide FY 2007 Basic Financial Statements, this audit report should not be disseminated separately from those statements.

We appreciate the courtesies extended to the audit staff. Please contact Mr. Daniel R. Blair (703) 325-6120 or Mr. Charles O. Egu at (703) 325-5961 if you have any questions.

Paul J. Granetto

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Service

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SUBJECT: Independent Auditor's Report on the FY 2007 DoD Financial Statements (Report No. D-2008-023)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2007 and 2006, and the Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, and the Combined Statement of Budgetary Resources, and related notes for the FYs then ended.[1] The basic financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to express an opinion on the DoD Agency-Wide FY 2007 Financial Statements because of limitations on the scope of our work. Thus, the basic financial statements may be unreliable. In addition to our disclaimer of opinion on the basic financial statements, we are including the required Report on Internal Control and Compliance with Laws and Regulations. The Report on Internal Control and Compliance with Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of our work.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that the DoD Agency-Wide FY 2007 Financial Statements would not substantially conform to accounting principles generally accepted in the United States of America (GAAP), and that DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2007. Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to performing only those audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. Therefore, we did not perform auditing procedures required by U.S. Government auditing standards and Office of Management and Budget (OMB) Bulletin No. 07-04 to determine whether material amounts on the financial statements were fairly presented. Prior audits have identified, and DoD has also acknowledged, the long-standing material internal control weaknesses identified in the Summary of Internal Control. These pervasive material weaknesses may affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the basic financial statements.[2] Therefore, we are unable to express, and we do not express, an opinion on the basic financial statements. Further, the purpose of the audit was not to express an opinion on Management Discussion and Analysis, Required Supplementary Stewardship

[1] Beginning in FY 2007, OMB Circular A-136 requires entities to present the Statement of Financing as a note. It is no longer considered a basic statement. In addition, DoD no longer prepares a Statement of Custodial Activity. DoD asserted that its Custodial Collections are immaterial and incidental to the agency's primary mission.

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

Information, Required Supplementary Information, Other Accompanying Information, and Performance Measures accompanying the basic financial statements. Accordingly, we express no opinion on that information.

As discussed in Note 25 to the financial statements, DoD has restated the FY 2006 basic financial statements. DoD made the restatements in order to account for changes in the reporting requirements for Allocation Transfers and to correct errors in the computation of the Distributed Offsetting Receipts reported on the Statement of Budgetary Resources. These restatements are material to the DoD Agency-Wide financial statements. Further, there has been no change to the previously issued disclaimer of audit opinion on the FY 06 basic financial statements.

As discussed in Notes 1.H, 1.Z, and 25 to the basic financial statements, DoD reported the programs it administers on behalf of the Executive Office of the President, including the Foreign Military Sales Program, in its FY 2007 basic financial statements. Previously, DoD recorded these programs as "Other Accompanying Information." DoD made this change to comply with new requirements in OMB Circular A-136 pertaining to allocation transfers. Because the impact of this change in accounting principle is material and pervasive, DoD, in coordination with OMB and the Treasury, restated the FY 2006 comparative columns on the financial statements and accompanying notes, rather than accounting for it as a change in accounting principle, as required by OMB Circular A-136.

As discussed in Notes 1.Z and 21 to the financial statements, effective FY 2007 DoD no longer prepares a Statement of Financing, and has presented the information formerly included in this Statement in Note 21, "Reconciliation of Net Cost of Operations to Budget" in accordance with the requirements contained in the revised OMB Circular A-136.

As discussed in Note 1.Z to the financial statements, effective FY 2007 DoD no longer prepares a Statement of Custodial Activity. DoD previously used the Statement of Custodial Activity to record collections and disbursements for three custodial accounts, including Foreign Military Sales. Because the Foreign Military Sales activity is no longer reported in the Statement of Custodial Activity, and the remaining DoD custodial activity is immaterial and incidental to DoD's primary mission, DoD has elected to disclose the remaining activity in Note 22, "Incidental Custodial Collections."

Summary of Internal Control

In planning our work, we considered DoD internal controls over financial reporting and compliance with applicable laws and regulations. We did this to determine our procedures for auditing the financial statements and to comply with OMB guidance, but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance with applicable laws and regulations. In addition, the Under Secretary of Defense (Comptroller)/Chief Financial Officer has acknowledged that she can offer no assurance on internal control over financial reporting. Previously identified control weaknesses, all of which are material, continued to exist in the following areas:

- **Financial Management Systems**
- **Fund Balance with Treasury**
- **Inventory**

- **Operating Materials and Supplies**
- **General Property, Plant, and Equipment**
- **Government-Furnished Material and Contractor-Acquired Material**
- **Environmental Liabilities**
- **Intragovernmental Eliminations**
- **Other Accounting Entries**
- **Statement of Net Cost**
- **Reconciliation of Net Cost of Operations to Budget**[3]
- **Accounts Payable**

We identified the following additional material weakness in FY 2007:

- **Accounts Receivable**

A material weakness is a significant deficiency, or a combination of significant deficiencies, resulting in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.[4]

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or a combination of control deficiencies, adversely affecting the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP.

Significant deficiencies result in more than a remote likelihood that a misstatement of an entity's financial statements that is more than inconsequential will not be prevented or detected. The following significant deficiency continued to exist:

- **Contingent Legal Liabilities**

We identified the following significant deficiency during FY 2007:

- **Cash and Other Monetary Assets**

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[3] This material weakness originally was presented as the Statement of Financing. Because OMB Circular A-136 requires entities to present the Statement of Financing as a note to the financial statements and the condition that caused the material weakness continued to exist, we renamed the material weakness to reflect the title of the new note.

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

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

Summary of Compliance with Laws and Regulations

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

Management's Responsibilities

Management is responsible for:

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

We provided a draft of this report to the Under Secretary of Defense (Comptroller)/Chief Financial Officer who then provided us technical comments, which we incorporated as appropriate. DoD officials expressed their continuing commitment to address the problems this report outlines.

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

Attachment:
As stated

Report on Internal Control and Compliance with Laws and Regulations

Internal Control

Management is responsible for implementing and maintaining effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly; that the requirements of applicable laws and regulations are met; and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, we have identified the following material weaknesses and significant deficiencies that could adversely affect the DoD financial management operations.

Previously Identified Material Weaknesses

Management acknowledged that previously identified control weaknesses, all of which are material, continued to exist in the following areas:

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

Fund Balance with Treasury. Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," the U.S. Treasury Manual, and DoD Financial Management Regulation 7000.14-R require DoD to resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury. However, inconsistencies continue to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, unreconciled differences in suspense accounts, and unreconciled differences between U.S. Treasury records and DoD accounting records.

Inventory. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," requires DoD to use historical cost, the latest acquisition cost (adjusted for holding gains and losses), or moving average cost for valuing inventory. However, DoD acknowledged that the existing inventory value for most activities is not reported in accordance with GAAP, and the Department's legacy systems do not maintain the historical cost data necessary to comply with Statement of Federal Financial Accounting Standards No. 3. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by Statement of Federal Financial Accounting Standards No. 3.

Attachment

Operating Materials and Supplies. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," states that Operating Materials and Supplies must be expensed when the items are consumed. DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when consumed. In addition, DoD cannot accurately report the value of operating materials and supplies, which causes the potential for a misstatement in financial reporting. For example, the Navy did not accurately report Sponsor-Owned Material in its FY 2006 Financial Statements. More than $2.5 billion of Sponsor-Owned Material was improperly classified and reported as Operating Materials and Supplies, including $1.9 billion of special tooling and test equipment, $481.6 million of aviation support equipment held for Foreign Military Sales, and $113.7 million of general support equipment. Those items should have been reported in the Inventory or General Property, Plant, and Equipment accounts.

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

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

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

Intragovernmental Eliminations. DoD disclosed that it cannot accurately identify most of its intragovernmental transactions by customer because the Department's systems do not track buyer and seller data needed to match related transactions. In addition, the Department is unable to fully reconcile intragovernmental transactions with all Federal partners. DoD acknowledged that its inability to reconcile most intragovernmental transactions results in adjustments that cannot be fully supported. For example, Defense Finance and Accounting Service (DFAS), Indianapolis Operations made $35.5 billion in unsupported adjustments to intragovernmental accounts to force the accounts to agree with the records of Army's trading partners.

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, DFAS, Indianapolis Operations recorded $258.2 billion in unsupported accounting entries to prepare the FY 2006 Army General Fund Financial Statements.

Statement of Net Cost. Statement of Federal Financial Accounting Concepts No. 2, "Entity and Display," requires the Statement of Net Cost to provide an understanding of the net costs of each organization and each program. In addition, the Statement of Net Cost should provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost.

- The amounts presented for General Funds may not report actual accrued costs.
- Although the funds are generally recorded on an accrual basis for Working Capital Funds, as required by GAAP, the systems do not always capture actual costs in a timely manner.
- The Statement of Net Cost is not presented by programs that align with major goals and outputs described in DoD's strategic and performance plans required by the Government Performance and Results Act.
- Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.

Reconciliation of Net Cost of Operations to Budget. Statement of Federal Financial Accounting Standards No. 7, "Accounting for Revenue and Other Financing Sources" requires a reconciliation of proprietary and budgetary information to assist users in understanding the relationship between the net cost of operations and the budgetary resources obligated by the entity during the period. During FY 2007, OMB rescinded the requirement to report this reconciliation as a Statement of Financing and now requires the disclosure of the information as a note to the financial statements. DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making unsupported adjustments. Specifically, budgetary data do not agree with proprietary expenses and capitalized assets. DoD made unsupported adjustments of $2 billion (absolute value) to reconcile obligations to the Statement of Net Cost. In addition, the Army General Fund is unable to accurately represent the relationship between budgetary obligations incurred and its Statement of Net Costs without preparing $22.9 billion in unsupported adjustments to the general ledger accounts to force costs to match obligation information.

Accounts Payable. According to Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," "… a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future." DoD acknowledged that it does not meet accounting standards for the financial reporting of public accounts payable. DoD cannot support its accounts payable balances because it lacks standard procedures for recording, reporting, and reconciling the amounts between the financial, accounting, and reporting systems. DoD identified Accounts Payable as a material weakness based on its FY 2007 assessment of internal control over financial reporting as required by OMB A-123 Appendix A. Additionally, our Independent

Auditor's reports on Internal Control for the FY 2007 Army General and Working Capital Funds, Navy General and Working Capital Funds, and the U.S. Army Corps of Engineers, Civil Works, identified Accounts Payable as a material weakness. These Components accounts payable balances comprised more than 54 percent of the DoD-Wide combined Accounts Payable balance as of September 30, 2007.

Material Weakness Identified During FY 2007. As a result of our financial-related audit work during FY 2007, we identified the following material internal control weakness:

Accounts Receivable. According to Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," a receivable should be recognized when a Federal entity establishes a claim to cash or other assets against other entities, either based on legal provisions, or goods and services provided. DoD acknowledged that it is unable to accurately record, report, collect, and reconcile intragovernmental accounts receivable as well as accounts receivable due from the public. DoD identified Accounts Receivable as a material weakness based on its FY 2007 assessment of internal control over financial reporting as required by OMB Circular No. A-123 Appendix A. Also, our independent auditor's reports on internal control for the FY 2007 Navy General and Working Capital Funds, Army General Fund, and the U.S. Army Corps of Engineers, Civil Works, showed accounts receivable to be a material weakness. These Components' accounts receivable balances comprised approximately 60 percent of the DoD-Wide combined accounts receivable balance as of September 30, 2007. For example,

- In the Army General Fund, there was a lack of controls to ensure that all entitlement system receivables (vendor pay, civilian pay, and interest) were recorded in the accounting systems and to ensure that accounts receivable balances were supported at the transaction level. As a result, DFAS, Indianapolis Operations made $1.1 billion in unsupported adjustments for FY 2007 that decreased the accounts receivable balances by $845.1 million.

- In the Navy General Fund, audit trails for accounts receivable were inadequate, and accounts receivable subledgers did not reconcile with the general ledger.

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

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

- DoD excluded from its legal representation letters at least 74 pending cases, with a total claim amount of $3.7 billion, that individually did not exceed the DoD Agency-Wide individual reporting threshold, but in aggregate exceeded this threshold.

- The legal representation letters from the DoD Office of General Counsel showed that DoD General Counsel was unable to express an opinion on the likely outcome of 55 of the 65 pending legal actions, totaling $1.57 trillion.

- The Army legal representation process did not provide meaningful assessments of potential liabilities and was not linked to the Army process for reporting and disclosing contingent legal liabilities on the financial statements. The legal representation letter from the Army Office of General Counsel and its attached management schedule did not corroborate either the $443.2 million reported on the Balance Sheet as part of Non-Federal Other Liabilities or the $446.8 million disclosed as contingent legal liabilities on Note 16 in the FY 2007 Army General Fund Financial Statements.

Significant Deficiency Identified During FY 2007. During FY 2007, we noted a significant deficiency related to Cash and Other Monetary Assets.

Cash and Other Monetary Assets. In the Army General Fund, internal and physical controls over Army Cash and Other Monetary Assets were inadequate, and cash in custody of agents reported on the Monthly Accountability Form (Standard Form 1219) was unreliable and unauditable. DFAS, Indianapolis Operations used its monthly Consolidated Statement of Accountability to make a $2.18 billion adjustment to the accounting records. Because Army and DFAS were not in compliance with reporting and control requirements mandated by OMB and DoD, there was no assurance that cash transactions were recorded, accumulated, and reported properly and that cash was adequately safeguarded. In addition, Army may have materially overstated the $2.18 billion of Cash and Other Monetary Assets reported on the Army General Fund Balance Sheet.

These financial management deficiencies may cause inaccurate management information and the DoD basic financial statements may also contain misstatements resulting from these deficiencies. As a result, DoD management and other users' decisions based in whole or in part on this information may be adversely affected.

Compliance with Laws and Regulations

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

Federal Financial Management Improvement Act of 1996. The Federal Financial Management Improvement Act of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable GAAP, and the U.S. Government Standard General Ledger at the transaction level. The Federal Financial Management Improvement Act also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management system requirements. The remediation plan is to include remedies, resources, and milestones. For FY 2007, DoD did not comply with the Federal Financial Management Improvement Act. DoD acknowledged that many of its financial management and feeder systems did not substantially comply with Federal financial management system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2007.

Government Performance and Results Act. Congress enacted the Government Performance and Results Act of 1993 (GPRA) to establish strategic planning and performance measurement in the Federal Government. Strategic plans, annual performance plans, and annual program performance reports comprise the main elements of GPRA. DoD did not fully comply with the requirements of GPRA and subsequent implementation guidance in OMB Circular A-11, "Preparation, Submission, and Execution of the Budget." Specifically, DoD did not have a compliant strategic plan for FY 2007 because DoD designated the Quadrennial Defense Review report, (which was prepared to fulfill the specific legislative requirements for a Quadrennial Defense Review) as its strategic plan without considering other requirements specified in GPRA. As a result, DoD performance budget and performance report for FY 2007 did not comply with the requirements of GPRA and OMB Circular A-11.

Antideficiency Act. Section 1341, Title 31, United States Code limits DoD and its agents to make or authorize only expenditures or obligations that do not exceed the amount available in the appropriations or funds for the expenditures or obligations. Also, DoD, and its agents, may not contract or obligate for the payment of money before an appropriation is made available for that contract or obligation unless otherwise authorized by law. During FY 2007, DoD reported 17 cases where actual violations of the Antideficiency Act occurred.

Section 1341, Title 31, United States Code states that if an officer or employee of an executive agency violates the Antideficiency Act, the head of the agency must report immediately to the President and Congress all relevant facts and a statement of the actions taken. DoD internal guidance limits the time between identification and reporting violations of the Antideficiency Act to 12 months. Our review of DoD Antideficiency Act investigations of potential violations shows that DoD did not report Antideficiency Act violation cases within the 12-month time limit.

Prompt Payment Act. The Prompt Payment Act requires the payment date for an invoice to be the date payment is due under the contract or 30 days after a proper invoice is received (if a specific payment date is not established by the contract). The Prompt Payment Act also states that an agency must make payments no more than 7 days prior to the payment due date unless the agency head or designee has determined that earlier payment is necessary. The Act requires DoD to maintain an internal control environment in accordance with OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004. In prior audit reports, we identified internal control weaknesses in the DFAS Columbus contractor payment system, "Mechanization of Contract Administration Service," that resulted in incorrect payments of interest to contractors. If controls governing compliance with the Prompt Payment Act are not corrected, DFAS Columbus could continue to pay a significant number of interest payments incorrectly and violate the provisions of the Prompt Payment Act.

Improper Payments Information Act. DoD does not fully comply with the requirements of the Improper Payments Information Act of 2002, Public Law 107-300, and subsequent OMB guidance. Specifically, DoD was still in the process of developing procedures to implement OMB's August 2006 guidance that requires additional documentation related to the identification of improper payments. The new OMB guidance requires that when an agency is unable to discern whether a payment was proper because of insufficient or lack of documentation, the payment must be considered an error. In addition, DoD efforts to manage recovery audit contracts have been largely unsuccessful. Further, in the FY 2006 Performance and Accountability Report, DoD overstated the amount identified through recovery audits by $64 million. The Department needs to disseminate guidance to improve contracting for recovery audits and adhere to that guidance in reporting recovered funds.

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

Audit Disclosures

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us on September 17, 2007, that the DoD financial management and feeder systems cannot provide adequate evidence supporting various material amounts on the financial statements, and previously identified material weaknesses continue to exist. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did not perform audit work related to the following selected provisions of laws and regulations: Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act), Federal Credit Reform Act, and the Pay and Allowance System for Civilian Employees.

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

Attachment