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*DEPARTMENT OF DEFENSE*

*AGENCY-WIDE  
FINANCIAL STATEMENTS*

*AUDIT OPINION*

*Audit Opinion*

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

February 26, 2002

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)**

**SUBJECT: Independent Auditor's Report on the Department of Defense Fiscal Year 2001 Agency-Wide Financial Statements (Report No. D-2002-055)**

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires the Inspector General, DoD, to audit the annual financial statements of the Department of Defense. We attempted to audit the accompanying Consolidated Balance Sheet of the Department of Defense as of September 30, 2001, and the related Consolidated Statements of Net Cost and Changes in Net Position, the Combined Statement of Financing, the Combined Statement of Budgetary Resources, and the Statement of Custodial Activity for the fiscal year then ended. In addition to our disclaimer of opinion of the financial statements, we are including the required report on internal control and compliance with laws and regulations.

These financial statements are the responsibility of DoD management. DoD management is also responsible for implementing effective internal control and for complying with laws and regulations.

**Disclaimer of Opinion**

We did not obtain sufficient, competent evidential matter to support the material line items on the financial statements. The Under Secretary of Defense (Comptroller) acknowledged to us that DoD financial management and feeder systems did not provide adequate evidence supporting various material amounts on the financial statements. DoD management further acknowledged that the Department is unable to comply with requirements for (i) property, plant, and equipment; (ii) inventory and operating materials and supplies; (iii) military retirement health care actuarial liability; (iv) intragovernmental eliminations and related accounting adjustments; (v) cost accounting by suborganization/responsibility segment and major program; and (vi) environmental liabilities. It was not practicable to extend our auditing procedures sufficiently to support the conclusions for these items related to the financial statements.

Because we did not apply auditing procedures to satisfy ourselves as to the accuracy of the reported amounts, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

**Required Additional Information**

The Supporting Consolidating and Combining Financial Statements (section 4), the Required Supplementary Stewardship Information (section 5), and Required Supplementary Information (Section 6) are not a required part of the principal financial statements. We did not apply certain procedures prescribed by professional standards because most of the information included in the above sections is produced from the same financial and feeder systems as the financial statements. As with the statements, it was not practicable to extend our limited procedures to obtain assurance regarding the reliability of the information. We did not audit and do not express an opinion on such information. DoD did not present information on

National Defense Property, Plant, and Equipment that the Federal Accounting Standards Advisory Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

### **Summary of Internal Control**

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data is accumulated, recorded, and reported properly and that assets are safeguarded. Our audit work on internal control was limited to following up on DoD corrective actions related to material weaknesses we reported in prior year audits that affect the financial statements. The follow-up work identified uncorrected material weaknesses in several areas including system deficiencies, intragovernmental eliminations, environmental liabilities, inventory, and the Statement of Net Cost. Because we did not test elements of DoD internal control, we did not obtain sufficient evidence to support an opinion on internal control over financial reporting. Thus, we do not express an opinion on internal control. See Attachment for additional details on material internal control weaknesses.

### **Summary of Compliance with Laws and Regulations**

Management is responsible for compliance with existing laws and regulations related to financial reporting. We performed some tests of DoD compliance with laws and regulations over financial reporting; however, the scope of the audit work was limited. Therefore, we did not obtain sufficient evidence to support or express an opinion on compliance.

We did not perform tests of DoD compliance with multiple statutory requirements to report on the status of financial management systems. The Under Secretary of Defense (Comptroller) acknowledged that many DoD financial management systems did not comply with Federal financial systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. Prior audits support the Department conclusions. In an attempt to comply with future statutory reporting requirements and applicable financial systems requirements, DoD is developing a DoD-Wide financial management enterprise architecture. Until the architecture is developed, DoD will be unable to fully comply with the statutory reporting requirements. DoD also did not comply with selected provisions of the Government Performance and Results Act and the Prompt Pay Act. See the Attachment for additional details on compliance.



David K. Steensma  
Acting Assistant Inspector General  
for Auditing

Attachment  
As stated

# **Report on Internal Control and Compliance With Laws and Regulations**

## **Internal Control**

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data is accumulated, recorded, and reported properly and that assets are safeguarded. We did not perform tests of DoD internal control over financial reporting; therefore, we did not obtain sufficient evidence to support or express an opinion on internal control. We limited our internal control review to following up on the status of DoD corrective actions related to material weaknesses we reported in prior year audits that affect the financial statements. Our review identified uncorrected material weaknesses in the following areas.

## **DoD Financial Management Systems**

The Federal Financial Management Improvement Act mandates that financial management systems comply with Federal financial system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. However, DoD has had long standing financial management problems chronicled by General Accounting Office and Inspector General, DoD audit reports that document system deficiencies. The Under Secretary of Defense (Comptroller) (USD([C])) acknowledged that DoD financial management systems are flawed with decade-old problems and lack the capability to provide reliable and timely information to DoD decision makers. To overcome the deficiencies, in 2000, the USD(C) began efforts to institute a Year 2000-like management approach. On January 5, 2001, the USD(C) issued a memorandum formally approving the DoD Financial and Feeder Systems Compliance Process. The goal of the DoD Financial and Feeder System Compliance Process is to ensure that critical financial and feeder systems are compliant with applicable Federal financial management systems requirements and to enhance the systems' capabilities to provide timely and accurate financial data to aid decision making. The DoD Financial and Feeder Systems Compliance Process has not yet been fully implemented throughout DoD. The Air Force and the Defense Finance and Accounting Service (DFAS) have completed substantial work in implementing their own Year 2000-like compliance processes. However, the Army, Navy, Air Force, DFAS, Defense Logistics Agency, and several other defense organizations needed to do more work toward implementing the DoD Financial and Feeder Systems Compliance Process.

Additionally, on July 19, 2001, the Secretary of Defense issued a memorandum establishing a Department-Wide Financial Modernization Program. The purpose of the program is to ensure reliable, accurate, and timely financial management information upon which to make effective management decisions. Following the memorandum from the Secretary of Defense, the USD(C) issued a memorandum on October 12, 2001, requiring DoD Components to control further investment in financial and non-financial feeder systems until the impact of further investment on the Enterprise Architecture can be assessed.

## **Intragovernmental Eliminations**

DoD continued to have problems properly identifying and eliminating intragovernmental transactions. Prior audit results reported that DoD accounting systems did not capture trading

partner data (data on transactions between DoD and other Federal agencies) at the transaction level in a manner that facilitates trading partner aggregations. As a result, DoD eliminated billions of dollars of intradepartmental expenses, revenue, accounts payable and other liabilities, and accounts receivable and other assets that could not be verified. For FY 2001 DoD acknowledged that, for the most part, the DoD accounting systems did not capture trading partner information at the transaction level. Therefore, current systems could not produce the data necessary for reconciliations between buyers and sellers.

### **Accounting Entries**

We reported that DoD processed \$1.1 trillion in unsupported accounting entries to DoD Component financial data used to prepare departmental reports and DoD financial statements for FY 2000. For FY 2001, we did not attempt to quantify amounts of unsupported accounting entries; however, we confirmed that DoD continued to enter material amounts of unsupported accounting entries to the financial data. The General Accounting Office "Standards for Internal Control in the Federal Government," November 1999, states that control activities should include reconciliations. However, during the compilation of the DoD Component financial data, the Defense Finance and Accounting Service (DFAS) processed material amounts of accounting entries to force general ledger accounting data to agree with budgetary accounting data, without attempting to reconcile the differences between the two data sources or to determine which data source was correct.

### **Fund Balance With Treasury**

DoD did not resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury in accordance with Statement of Federal Financial Accounting Standard (SFFAS) No. 1. We identified \$17.3 billion in inconsistencies that affected the accuracy of Fund Balance with Treasury as of September 30, 2001. These differences included \$12.4 billion of disbursement disparities including in-transit disbursements, unmatched disbursements, and negative unliquidated obligations; \$3.6 billion in unreconciled differences between U.S. Treasury records and DoD disbursing station records for deposits, interagency transfers, and checks issued; and \$1.3 billion in unreconciled suspense account balances.

### **Problem Disbursements**

Problem disbursements reported by DoD decreased \$1.6 billion (from \$2.8 billion to \$1.2 billion) during FY 2001. Problem disbursements include unmatched disbursements, and negative unliquidated obligations.

- Unmatched disbursements occur when the accountable station cannot match the disbursement to the correct detail obligation.
- Negative unliquidated obligations occur when the disbursement exceeds the amount of the recorded unliquidated obligation.

Unmatched disbursements decreased \$0.6 billion and negative unliquidated obligations decreased \$1.0 billion. The reduction was achieved through various actions taken by DFAS, including the obligation of \$1.4 billion from January 2001 through September 2001. DFAS obligated these funds to be in accordance with DoD Financial Management Regulation 7000.14-R, volume 3, chapter 11.

## **Military Retirement Health Care Liability**

Prior audit results disclosed data quality deficiencies in recording and reporting information within the military health care system. The Assistant Secretary of Defense for Health Affairs initiated a program to improve the data quality in military health care information systems. Although progress was made, additional steps need to be taken to provide better guidance, improve training, and improve data quality metrics. Also, the TRICARE Management Activity had not provided reasonable assurance that selected information assurance controls over the Source Data Collection System were adequate. The lack of controls over that system increased the vulnerability of reporting unreliable financial data.

## **Environmental Liabilities**

DoD reported \$63.3 billion for environmental liabilities for FY 2001. DoD has not yet implemented all procedures necessary to accurately report this amount. Although there have been some significant steps toward increasing the reliability of the financial statements, DoD has not had time to implement all auditor recommendations. SFFAS No. 5 provides guidance for recognition of liabilities where the future outflow of resources is probable and reasonably estimable. SFFAS No. 6 provides accounting guidance for environmental cleanup and disposal liabilities related to property, plant, and equipment. Prior audit reports address problems in five main areas. These five areas are:

- clarification, expansion, and implementation of guidance;
- standardization and verification, validation, and accreditation of the methods to estimate cost-to-complete;
- completion of DoD range inventories;
- adequacy of audit trails for cost-to-complete system and
- adequacy and accuracy of data calls.

Deficiencies in these five areas remain uncorrected or adequate time has not elapsed to impact the amounts reported for environmental liabilities on the FY 2001 DoD Agency-Wide financial statements.

## **General Property, Plant, and Equipment**

For FY 2001, DoD reported \$113.8 billion in General Property, Plant, and Equipment, which includes real property and personal property. DoD acknowledged that deficiencies related to the proper reporting of real property identified in prior audit reports continued to exist. Internal control weaknesses, system deficiencies, and the lack of adequate personnel training affected the accurate reporting of real property in accordance with SFFAS No. 6 & SFFAS No. 10. To coordinate and oversee efforts to resolve these deficiencies, the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics, along with the USD(C) established the Property, Plant, and Equipment Program Management Office. The initiatives being pursued by the program management office will address deficiencies in the reporting of real property, personal property, and property in the possession of contractors.

## **Government Furnished Material and Contractor Acquired Material**

DoD has acknowledged that it continues to have reporting deficiencies related to Government Furnished Material and Contractor Acquired Material. SFFAS No. 3 requires that Government Furnished Material and Contractor Acquired Material be reported under Operating Materials and Supplies. DoD disclosed in the footnotes to the financial statements that Government Furnished Material and Contractor Acquired Material are not included in the Operating Materials and Supplies values. DoD states that the Department is presently reviewing its process for reporting these amounts in an effort to determine the appropriate accounting treatment and the best method to collect and report the required information.

## **Inventory**

DoD has not yet implemented procedures to accurately report the amount of inventory in accordance with SFFAS No. 3. Prior audit results showed that the values assigned to inventories in the Defense Logistics Agency Standard Automated Material Management System were not always accurate and a significant portion of the inventory value was not supported by contract data. DoD corrective actions for these deficiencies will not be implemented until FY 2002 at the earliest. Therefore, these deficiencies still existed in FY 2001.

## **Operating Materials and Supplies**

DoD has acknowledged that it continues to have problems reporting Operating Materials and Supplies in accordance with generally accepted government accounting standards. SFFAS No. 3 requires the use of the consumption method. Instead, DoD disclosed in the footnotes to the financial statements that for FY 2001, significant amounts of Operating Materials and Supplies were reported under the purchase method.

## **The Statement of Net Cost**

The program categories used for the FY 2001 DoD Agency-Wide Consolidated Statement of Net Cost were not consistent with the DoD performance goals and measures. Office of Management and Budget (OMB) Bulletin 01-09 states “the Statement of Net Cost should present responsibility segments that align directly with major goals and outputs described in the entity’s strategic and performance plans, required by the Government Performance and Results Act (GPRA).” Instead, DoD reported revenues and expenses for appropriation categories. DoD acknowledged that it did not accumulate costs for major programs based on performance measures, in part because its financial processes and systems do not collect costs in line with performance measures.

## **The Statement of Financing**

The Statement of Financing also reports Net Cost; however, the Statement of Financing is prepared on a combined basis whereas the Statement of Net Cost is prepared on a consolidated basis. Two lines on the Statement of Financing were materially adjusted. The Costs Capitalized on the Balance Sheet line was adjusted by \$19 billion and the Other line was adjusted by \$5.6 billion to force both statements to report identical amounts for Net Cost.



## Systems Security

For FY 2000, we identified multiple systems security deficiencies. DoD has made progress in meeting the information assurance challenge. However, 59 reports issued and testimonies given by the General Accounting Office; Inspector General, DoD; and the Service audit agencies from April 2000 through August 22, 2001, show continued weaknesses in the following areas<sup>1</sup>:

- security policies and procedures,
- information security training
- information security assessment, and
- contingency planning.

We reported weaknesses in our FY 2000 report on Internal Controls and Compliance with Laws and Regulations. The following weaknesses continued to exist.

**Integrated Accounts Payable System (IAPS).** Annually, DFAS uses IAPS to process billions of dollars in vendor payments for Air Force customers. For FY 2000, we reported that controls over IAPS did not effectively prevent unwarranted and unauthorized system access and ensure adequate audit trails. For FY 2001, DFAS changed access levels of personnel. However, controls over IAPS still did not effectively prevent unwarranted and unauthorized system access and ensure adequate audit trails. As a result, IAPS vulnerabilities were not minimized.

**U.S. Army Corps of Engineers Systems.** In FY 2001, the General Accounting Office reported weaknesses and vulnerabilities in computer controls at the U.S. Army Corps of Engineers data processing centers and revealed serious system vulnerabilities at other Corps of Engineers sites. The General Accounting Office noted that serious general control weaknesses impaired the Corps of Engineers ability to protect computer resources, limit access to computer programs and files, control powerful systems software, ensure that only authorized programs were placed in operation, and enforce proper segregation of duties. Although some progress has been made since the report, numerous recommendations for corrective action have not been implemented. Therefore, the associated risks to data produced for the Corps of Engineers, a component of the DoD Agency-Wide financial statements, were high.

## Indicators of Fraud and Illegal Acts

The American Institute of Certified Public Accountants Statement of Auditing Standard No. 82, "Consideration of Fraud in a Financial Statement Audit," February 1997, requires auditors to assess the risk of material misstatement due to fraud or illegal acts in order to provide reasonable assurance that fraud or illegal acts material to the financial statements are detected.

Our audit procedures were limited due to acknowledged DoD deficiencies in financial management and accounting systems, audit trails, and control over assets. Therefore, we were not able to obtain sufficient evidence to provide reasonable assurance that fraud or illegal acts were detected. However, we identified no material instances of fraud or illegal acts. We are

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<sup>1</sup>Inspector General, DoD, Report No. D-2001-182, "Information Assurance Challenges—A Summary of Results Reported April 1, 2001, through August 22, 2001," September 19, 2001

unable to report the effect that fraud risk factors had on the FY 2001 DoD Agency-Wide Financial Statements. Nonetheless, DoD financial management deficiencies are indications of internal control weaknesses that significantly impair DoD ability to monitor, detect, and investigate fraud or theft of assets. A high risk of material misstatements due to fraud or illegal acts will continue to be present until internal control deficiencies within DoD are remedied.

## **Results of Material Weaknesses**

The results of the previously identified material control weaknesses are that we cannot form opinions as to the accuracy of the financial statements and the effectiveness of internal control. This report does not include recommendations to correct these material weaknesses because previous audit reports contained recommendations for corrective actions.

## **Compliance with Laws and Regulations**

Management is responsible for compliance with existing laws and regulations related to financial reporting. We performed limited tests of DoD compliance with laws and regulations over financial reporting. Because the scope of our audit work was limited, we did not obtain sufficient evidence to support or express an opinion on compliance.

**Statutory Financial Management Systems Reporting Requirements.** DoD is required to comply with the following financial management systems reporting requirements.

Section 3512, Title 31, United States Code (U.S.C.) incorporates the reporting requirements of the Federal Managers' Financial Integrity Act of 1982 and requires DoD to evaluate the systems and to annually report whether those systems are in compliance with applicable requirements.

The Chief Financial Officers Act of 1990 requires DoD to prepare a Five-year Financial Management Plan describing activities that DoD will conduct during the next 5 years to improve financial management.

The Federal Financial Management Improvement Act of 1996 requires the Inspector General, DoD, to report whether DoD financial management systems substantially comply with Federal financial management system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

For FY 2001, DoD did not satisfy its statutory reporting requirements identified in the provisions above. DoD did acknowledge that many of its critical financial management systems do not comply with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. Prior audits support the Department's conclusions. In an attempt to comply in the future with statutory reporting requirements and applicable financial systems requirements, DoD is developing a DoD-wide financial management enterprise architecture. The architecture is intended to provide a "blueprint" of the Department's financial management systems and processes to initiate a comprehensive financial management reform effort. Until the architecture is developed, DoD is unable to fully comply with the statutory reporting requirements. We did not perform tests of compliance for these requirements.

## Reporting GPRA Goals and Performance Measures in the Financial Statements

GPRA was enacted to improve the confidence of the American people in the Federal Government's ability to hold Federal agencies accountable for achieving program results. GPRA requires that each Federal agency prepare a strategic plan and annual performance plans and reports. DoD reported two corporate-level goals and eight performance goals in its GPRA Performance Plan for FY 2001. DoD added an additional performance goal in FY 2001 that directly relates to improving the Department financial and information management. Three performance measures were established.

**Performance Measure 2.5.1** – Reduce the Number of Noncompliant Accounting and Finance Systems.

**Performance Measure 2.5.2** – Achieve Unqualified Opinions on Financial Statements.

**Performance Measure 2.5.3** – Qualitative Assessment of Reforming Information Technology Management.

In an attempt to meet its goals, DoD is developing a DoD-wide financial management enterprise architecture. Until the architecture is developed, DoD is unable to fully measure its performance goals related to financial and information management.

OMB Bulletin 01-09 requires that DoD include GPRA-related information in the financial statements. The Overview section of the DoD Agency-Wide Financial Statements is required to contain a discussion of GPRA performance measures and provide a link between those performance measures and the programs presented in the Statement of Net Cost. ¶ However, the Overview section of the FY 2001 DoD Agency-Wide Financial Statements did not specifically address DoD GPRA performance measures, but does provide DoD high-level vision for transforming financial management.

OMB guidance also requires that the program cost categories reflected in the Statement of Net Cost be consistent with the DoD GPRA Performance Plan as published in the Annual Defense Report. Because of system limitations, DoD did not link the data reported on the Statement of Net Cost to the FY 2001 performance measures.

## Prompt Pay Act Requirements

The Prompt Pay Act requires the payment of interest to vendors if payments are not made within a prescribed payment period. The Act requires that an interest penalty must be paid beginning on the day after the required payment due date and ending on the date on which the payment is made. Generally, the payment due date is 30 days after the later of the date of invoice receipt or the actual or constructive acceptance of goods or services. If the invoice receipt date is not properly stamped on the invoice at the time of receipt by the designated billing office, the date of the invoice will be used in computing the payment due date. DoD was not fully complying with the provisions of the Prompt Payment Act. The dates used to compute payment due dates were not always valid and resulted in computing improper payment due dates. As a result, vendors were not always paid interest penalties in the proper amount for late payment invoices.

## Results of Noncompliance

The results of the previously identified instances of noncompliance are that we cannot form an opinion on the DoD ability to comply with laws and regulations that materially affect the

financial statements. This report does not include recommendations to correct these types of deficiencies because previous audit reports contained recommendations for corrective actions.

## **Audit Disclosures**

We were unable to conduct this audit in full accordance with government auditing standards. The USD(C) acknowledged to us on October 31, 2001, that the DoD financial management systems cannot provide adequate evidence supporting various material amounts on the financial statements. Our review of internal control was limited to performing follow-up work on deficiencies identified in previous audit reports. As a result, we were unable to form an opinion as to the accuracy of the amounts reported on the financial statements or to form an opinion on internal control.

We did not perform tests of DoD compliance with the Federal Managers' Financial Integrity Act, Federal Financial Management Improvement Act, and the Chief Financial Officers Act because DoD financial management systems did not comply substantially with Federal financial management systems requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. We performed limited tests of DoD compliance with other laws and regulations that have a direct and material effect on the financial statement and required supplementary stewardship information.

We did not conduct audit follow-up work related to the following deficiencies identified in the FY 2000 DoD Agency-Wide financial statement audit: Statement of Budgetary Resources, Defense Civilian Pay System, Defense Joint Military Pay System, and the Debt Collection Improvement Act. We did not perform audit tests of DoD compliance with the Anti-Deficiency Act or the Pay and Allowance System for Civilian Employees.