

# **Independent Auditors' Report on the Principal Statements**



INSPECTOR GENERAL  
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December 10, 2003

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

SUBJECT: Independent Auditor's Report on the Department of Defense Fiscal  
Year 2003 Agency-Wide Principal Financial Statements  
(Report No. D-2004-036)

The Chief Financial Officers (CFO) Act of 1990, as amended, requires the Inspector General of the Department of Defense to audit the accompanying DoD Consolidated Balance Sheet as of September 30, 2003 and 2002, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Combined Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended. The financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. In addition to our disclaimer of opinion on the financial statements, we are including the required reports on internal control and compliance with laws and regulations.

### **Disclaimer of Opinion on the Financial Statements**

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that (1) DoD financial management systems do not substantially comply with Federal financial management systems requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level and (2) DoD financial management and feeder systems cannot provide adequate evidence to support various material amounts on the financial statements. Therefore, we did not perform auditing procedures to determine if material amounts on the financial statements were fairly presented. In addition, other auditing procedures were not performed because Section 1008(d) of the FY 2002 National Defense Authorization Act requires the Inspector General of the Department of Defense to perform only the audit procedures required by generally accepted government auditing standards that are consistent with representations made by DoD management.<sup>1</sup> DoD has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also affect the reliability of other information contained in the annual financial statements, much of which is taken from the same data sources as the principal financial statements.<sup>2</sup> These deficiencies would have precluded an audit

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<sup>1</sup>We performed audit work on the U.S. Army Corps of Engineers account balances during FY 2003 because management asserted that their financial statements were ready for audit. In addition, we performed audit work on the DoD Environmental Liability account balance because management asserted that the account balance was ready for audit.

<sup>2</sup>The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

*A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.* —Constitution of the United States, Article I, Section 9

opinion. Therefore, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

## **Summary of Internal Control**

In planning our audit, we considered DoD internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance but not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance because previously identified reportable conditions,<sup>3</sup> all of which are material, continued to exist in the following areas:

- financial management systems;
- Fund Balance with Treasury;
- Inventory;
- Operating Materials and Supplies;
- Property, Plant, and Equipment (PP&E);
- Government-Furnished Material and Contractor-Acquired Material;
- Environmental Liabilities;
- intragovernmental eliminations and other accounting entries;
- Statement of Net Cost; and
- Statement of Financing.

A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance that are material in relation to the financial statements would be prevented or detected on a timely basis. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on 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, and prior audits confirm, that instances of noncompliance continue to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that DoD financial management systems do not comply substantially with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level.

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<sup>3</sup> Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

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Our work supports DoD conclusions and confirms that uncorrected instances of noncompliance continue to exist related to other provisions of laws and regulations.

In order for DoD to comply with statutory reporting requirements and applicable financial management systems requirements, the Under Secretary of Defense (Comptroller)/Chief Financial Officer is developing a DoD-wide Business Enterprise Architecture. It is unlikely that DoD will be able to fully comply with the statutory reporting requirements until the architecture is fully developed and implemented. See the Attachment for additional details on compliance with laws and regulations.

We caution that other noncompliance may have occurred and not been detected. Further, the results of our limited procedures may not have been sufficient for other purposes. Our objective was not to express an opinion on noncompliance with applicable laws and regulations.

## Management Responsibility

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of section 3512, title 31, United States Code, which incorporates the reporting requirements of the Federal Managers' Financial Integrity Act (FMFIA) of 1982, are met;
- ensuring that DoD financial management systems substantially comply with Federal Financial Management Improvement Act (FFMIA) of 1996 requirements; and
- complying with applicable laws and regulations.



Paul J. Granetto, CPA  
Director  
Defense Financial Auditing  
Service

Attachment  
As stated

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# Reports 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 are recorded and reported properly; and that assets are safeguarded. We did not perform tests of DoD internal control over financial reporting and we did not obtain sufficient evidence to support or express an opinion on internal control because previously identified reportable conditions, all of which are material, continue to exist. The following financial management deficiencies are indications of internal control weaknesses that significantly impair the ability of DoD to prepare financial statements in compliance with generally accepted accounting principles and to detect and prevent fraud or theft of assets. A high risk of material misstatements will continue to exist until the internal control deficiencies are corrected.

**Financial Management Systems.** Statement of Federal Financial Accounting Concept (SFFAC) No. 1, "Objectives of Federal Financial and Reporting," requires financial management systems controls that are adequate to ensure that transactions: are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with federal accounting standards. SFFAC No. 1 also requires that financial management system controls ensure that 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 are unable to provide adequate evidence supporting various material amounts on the financial statements. Specifically, systemic deficiencies in financial management systems and business processes result in the inability to collect and report financial and that performance information that is accurate, reliable, and timely.

**Fund Balance With Treasury.** DoD is required by the U.S. Treasury Financial Manual and DoD Financial Management Regulation 7000.14-R, to resolve financial and accounting inconsistencies to accurately report Fund Balance with Treasury. However, inconsistencies continue to exist related to: in-transit disbursements; problem disbursements, including unmatched disbursements and negative unliquidated obligations; unreconciled differences in suspense accounts; and unreconciled differences between the Department of Treasury records and DoD disbursing stations for checks issued, deposits and electronic fund transfers, and interagency transfers. The absolute value of these inconsistencies was approximately \$20.6 billion as of March 31, 2003, and presents a major internal control problem for the Defense Finance and Accounting Service (DFAS). In addition, a survey of the managers of the 39 systems used at the 5 DFAS centers to identify and report in-transit and problem disbursements found that 1 system had been reviewed and 14 systems had not been reviewed for reliability. The remaining 24 system managers did not respond to the survey.

**Inventory.** DoD is required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," to use the latest acquisition cost adjusted for holding gains and losses or moving average cost for valuing Inventory. However, DoD acknowledged that the existing process for inventory valuation does not produce an auditable approximation of historical cost because the associated gains and losses cannot be accurately tracked to specific items or purchases.

Attachment

Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by SFFAS No. 3. Also, prior audit reports have identified inaccurate inventory records, deficiencies related to existence and completeness of inventory, and inaccurate inventory valuation.

**Operating Material and Supplies.** SFFAS No. 3 states that Operating Materials and Supplies shall be expensed when the items are consumed. However, DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when they were consumed. In addition, DoD acknowledged that significant amounts of Operating Materials and Supplies in the possession of contractors were not included in the Operating Materials and Supplies account balance.

**Property, Plant, and Equipment.** DoD acknowledged they could not support the reported cost of military equipment in accordance with generally accepted accounting principles because of an absence of detailed cost information. For additional details, see Note 10 to the financial statements. DoD also acknowledged that General PP&E is not reliably reported because legacy property and logistic systems were not designed to capture the acquisition cost and the cost of modifications and upgrades or calculate depreciation. In addition, there is a lack of supporting documentation for General PP&E with long useful lives.

**Government-Furnished Material and Contractor-Acquired Material.** SFFAS 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 is considered Government property. Government property should be accounted for based on the nature of the item, regardless of possession. DoD has acknowledged that it is unable to comply with applicable requirements for Government-Furnished Property 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 environmental guidance, inventory of ranges and operational activities (landfills, open burning pits, etc), and audit trails are incomplete. DoD also acknowledged that it did not recognize any unamortized clean-up costs associated with PP&E. In addition, we determined that data<sup>4</sup> and processes used for the Army Defense Environmental Restoration Program, non-Defense Environmental Restoration Program, and Army Base Realignment and Closure program resulted in unreliable Environmental Liability estimates. The Environmental Liability estimates were unreliable because Army activities did not have effective controls in place to: ensure adequate audit trails and documentation for supporting estimates, comply with established guidance in developing estimates, maintain reliable feeder and coordination systems, document supervisory review of estimates, and establish quality control programs.

**Intragovernmental Eliminations and Other Accounting Entries.** DoD acknowledged that it made unsupported adjustments with its trading partners because of the inability to reconcile most intragovernmental transactions. In addition, DoD acknowledged that material amounts of unsupported accounting entries continue to be made.

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<sup>4</sup>We reviewed environmental financial data as of September 30, 2002, as FY 2003 data were unavailable at the beginning of the audit in February 2003. Even though DoD is in the process of implementing corrective actions such as issuing policy guidance and correcting some feeder and coordination systems, we believe the FY 2003 environmental financial data continue to be unreliable.

**Statement of Net Cost.** SFFAC 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/or organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost:

- amounts presented in the Statement of Net Cost may not in all cases report actual accrued costs;
- transactions are generally recorded on a cash basis instead of an accrual basis as required by generally accepted accounting principles;
- costs cannot to be accumulated for major programs based on performance measures as required by the Government Performance and Results Act because current financial processes and systems do not capture and report this type of cost information;
- accounting systems do not capture cost data in a manner that enables DoD to determine if the cost was incurred to generate intragovernmental revenue; and
- accounting systems do not capture trading partner data at the transaction level in a manner that facilitates trading partner aggregations; therefore, DoD was unable to reconcile intragovernmental revenue balances with its trading partners.

**Statement of Financing.** The SFFAS No. 7, “Concepts for Reconciling Budgetary and Financial Accounting,” states that the Statement of Financing reconciles resources obligated during the period to the net cost of operations. However, DoD has acknowledged that it is unable to reconcile budgetary data to net costs. Specifically, budgetary data are not in agreement with proprietary expenses and assets capitalized. DoD disclosed in the notes to the financial statements that the Statement of Financing was adjusted by a net \$12.5 billion to match the Statement of Net Costs. In addition, DoD presented the Statement of Financing on a combined basis instead of the consolidated basis as required by the Office of Management and Budget (OMB) Bulletin 01-09, “Form and Content of Agency Financial Statements.”

### **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 express an opinion on compliance with applicable laws and regulations.

**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, incorporates the reporting requirements of the FMFIA of 1982 and requires DoD to evaluate its systems and to annually report whether those systems are in compliance with applicable requirements.
- The FFMIA requires DoD to establish and maintain financial management systems that comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger. The FFMIA also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management systems requirements. The remediation plan is to include remedies, resources required, and target dates.

For FY 2003, DoD did not fully satisfy the statutory reporting requirements identified in these provisions. DoD acknowledged that many of its critical financial management and feeder systems do not comply substantially with the Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In an attempt to comply with statutory reporting requirements and applicable financial management systems requirements, DoD is developing a DoD-wide Business Enterprise Architecture. However, the transition plan for the Business Enterprise Architecture falls short of meeting the requirements of a remediation plan under the FFMIA because it does not identify the resources that will be required to correct the noncompliance with Federal financial management system requirements.

The Business Enterprise Architecture, when completed, will provide a clear and comprehensive picture of DoD current or “As Is” operational and technological environment and its target or “To Be” environment. In addition, it will contain a capital investment plan for transitioning from the current to the target environment.

DoD relies on a complex and error-prone information technology environment that consists of approximately 2,300 systems that are not standardized across the Department. Consequently, it is unlikely that DoD will be able to fully comply with the statutory reporting requirements until the Business Enterprise Architecture is fully developed and implemented. Therefore, we did not perform tests of compliance for these requirements.

**National Defense Authorization Act of Fiscal Year 2003.** DoD complied with the Act’s requirements to develop a Business Enterprise Architecture for all DoD systems and a transition plan for implementing that Business Enterprise Architecture by the required due date of May 1, 2003. However, a General Accounting Office (GAO) report, “DoD Business Systems Modernization – Important Progress Made to Develop Business Enterprise Architecture, but Much Work Remains,” September 2003 (GAO-03-1018), states that the Business Enterprise Architecture does not adequately address Federal requirements and accounting standards as required by the Act. For example, GAO found that approximately 19 percent of Joint Financial Management Improvement Program requirements reviewed were not adequately addressed in version 1.0 of the “To Be” architecture. In addition, GAO found that DoD has not yet defined and implemented an effective approach to select and control business systems investments for obligations exceeding \$1 million while the Business Enterprise Architecture is being developed and after it is completed.



**Federal Information Security Management Act of 2002.** DoD is required to report on the adequacy and effectiveness of information security policies, procedures, practices, and compliance with various laws and regulations. DoD is also required to develop, document, and implement a DoD-wide information security program, approved by OMB, to provide information security for the information and information systems that support the operations and assets of DoD. However, DoD has not developed, documented, and implemented a DoD-wide information security program, approved by OMB, to provide information security for the information and information systems that support the operations and assets of DoD.

**Government Performance and Results Act of 1993.** The Act and OMB implementation guidance contained in OMB Circular No. A-11, "Preparation, Submission, and Execution of the Budget," and OMB Bulletin 01-09 requires DoD to issue a revised and updated strategic plan every 3 years, an annual performance plan by December 31 of the current fiscal year for each program activity, and an annual performance report identifying actual program performance. DoD has not revised and updated their strategic plan and the previously issued strategic plan does not comply with OMB guidance. DoD also did not issue an annual performance plan for FY 2003 and has yet to issue an annual performance plan for FY 2004. In addition, the DoD Annual Performance Report for FY 2003 does not fully comply with the requirements of the Act and OMB implementation guidance. For example, the Annual Performance report does not: evaluate the performance plan, summarize program evaluations completed during the fiscal year, or provide a description of any material inadequacies in the completeness and reliability of performance data. Additionally, DoD acknowledged that it is unable to accumulate costs for major programs based on performance measures identified by the Government Performance and Results Act.

**Prompt Payment Act of 1982.** DoD is required to pay interest penalties for late payments, adhere to due dates and make periodic payments for partial deliveries or other contract performance, review invoices as soon as possible after receipt to determine if the invoice is proper, and maintain an internal control environment in accordance with OMB Circular A-123, "Management Accountability and Control." We identified uncorrected deficiencies in the DoD control environment related to payments. Specifically, we identified deficiencies in internal control standards prescribed by OMB Circular A-123 to include: access and accountability for resources, recording and documentation, and segregation of duties.

## **Audit Disclosures**

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us on April 17, 2003, that DoD financial management systems cannot provide adequate evidence supporting various material amounts on the financial statements. As a result, we were unable to obtain adequate evidential matter to form or express an opinion on the financial statements, internal control, and compliance with laws and regulations.

We did not perform sufficient audit followup work of DoD compliance with selected provisions of the Antideficiency Act, the Debt Collection Improvement Act of 1996, the Pay and Allowance System for Civilian Employees, the Federal Credit Reform Act, and the Department of Defense Appropriation Act for FY 2003. We plan to perform audit tests of selected provisions of the previously discussed laws and regulations in the near future.

This report does not include recommendations to correct the material control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.