Message from the Chief Financial Officer

November 15, 2005

Throughout Fiscal Year 2005, the Department of Defense continued to improve financial management to provide better accountability to the taxpayers.

Today a comprehensive plan for business transformation and financial management improvement is in place and underway. The plan has three major components: the Business Enterprise Architecture, the Business Transition Plan, and the Financial Improvement and Audit Readiness (FIAR) Plan, which provides a roadmap for improving the Department's financial management capabilities.

The Financial Improvement and Audit Readiness Plan targets four strategic areas for improvement in the short term, and includes milestones that can be easily understood, measured, and adjusted as necessary. Each of the focus areas – Military Equipment, Real Property, Environmental Liabilities, and Health Care Liabilities – are central to achieving an unqualified audit opinion.

We developed and published the first phase of Standard Financial Information Structure (SFIS) which standardizes the budget and accounting codes used to classify financial activity across the Department. The SFIS not only complies with accounting standards and facilitates standard data entry but will enable us to consistently trace financial activity by maintaining a clean audit trail across the Department.

The challenges we face are complex, but I am confident that the plans and strategies we have put in place to address them are sound. Continued progress will depend on the timely implementation of critical business and financial systems modernization plans, committed and involved senior leadership, and adequate funding.

I am inspired by the many talented and hard-working DoD financial management professionals who are building upon past accomplishments and moving ahead with critical initiatives that will further improve the Department's financial performance and accountability.

Tina W. Jonas

Independent Auditors' Report on the Principal Statements

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

November 12, 2005

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

SUBJECT: Independent Auditor's Report on the Fiscal Year 2005 Department of Defense Agency-Wide Financial Statements (Report No. D-2006-022)

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, 2005 and 2004, 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. We are unable to give an opinion on the Fiscal Year 2005 DoD financial statements because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the 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 the audit.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that the FY 2005 DoD Agency-Wide Financial Statements would not substantially conform to generally accepted accounting principles, and DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2005. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. 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 certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial

statements.[1] 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 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. However, previously identified reportable conditions, all of which are material, continue to exist in the following areas.

- Financial Management Systems
- Fund Balance with Treasury
- Inventory
- Operating Materials and Supplies
- Property, Plant, and Equipment
- Government-Furnished Material and Contractor-Acquired Material
- Environmental Liabilities
- Intragovernmental Eliminations
- Accounting Entries
- Statement of Net Cost
- Statement of Financing

Material weaknesses are reportable conditions in which internal controls do not reduce (to a relatively low level) the risk of misstatements that are material to the financial statements and that might not be timely detected by employees while performing their normal, assigned functions.

In addition, we identified weaknesses in Accounts Payable, Accounts Receivable, and Contingent Legal Liabilities, which we consider to be reportable conditions. 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

[1] 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.

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.

Our internal control work would not necessarily disclose all reportable conditions. See the Attachment for additional details on reportable conditions, 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, 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. Therefore, we did not determine whether DoD was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with 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 the Federal Managers' Financial Integrity Act are met; and
- complying with applicable laws and regulations.

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

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

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 are accumulated, recorded, and reported properly 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 reportable conditions that could adversely affect a favorable opinion on internal control.

Material Weaknesses. Management acknowledged that previously identified reportable conditions, all of which are material, continue to exist.

Financial Management Systems. Statement of Federal Financial Accounting Concepts No. 1, "Objectives of Federal Financial 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. Statement of Federal Financial Accounting Concepts No. 1 also requires that financial management systems 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 many DoD financial management systems do not substantially comply with Federal financial management systems 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.

In addition, reviews of five DoD financial management systems and Defense Information Systems Agency Computing Services identified several common vulnerabilities. Controls over security planning, access controls, and software controls did not comply with DoD information assurance requirements. As a result, potential system and procedural vulnerabilities threatened the confidentiality, integrity, and availability of financial data.

Fund Balance with Treasury. The U.S. Treasury Financial 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. DoD is required by the Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," 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 valuation at most activities does not approximate historical cost. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by the standard.

Operating Materials and Supplies. Statement of Federal Financial Accounting Standards No. 3 also 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 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.

General Property, Plant, and Equipment. DoD is required by Statement of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," to record Property, Plant, and Equipment at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, DoD has acknowledged that it is unable to accurately report the value of Property, Plant, and Equipment on its financial statements. DoD legacy property and logistics systems were not designed to capture acquisition cost and costs of modifications and upgrades or to calculate depreciation. In addition, the value of DoD Property, Plant, and Equipment is not reliably reported because of a lack of supporting documentation.

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. Government property should be accounted for based on the nature of the item, regardless of who has possession. DoD has acknowledged, and prior audits confirm, that it is unable to comply with applicable 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 guidance and audit trails for estimating environmental liabilities are incomplete. Environmental liability estimates are unreliable because activities do not have effective controls in place to ensure that:

- they have adequate audit trails and supporting documentation for estimates,
- they comply with established guidance in developing estimates, and
- they maintain reliable feeder and coordination systems.

In addition, DoD has not developed policies, procedures, and methodologies needed to ensure that cleanup costs for all of its ongoing and inactive or closed operations are identified, consistently estimated, and appropriately reported.

Intragovernmental Eliminations. DoD acknowledged that it made unverifiable adjustments because of the inability to reconcile most intragovernmental transactions. For example, Defense Finance and Accounting Service Indianapolis entered more than $26 billion in unsupported adjustments to Army intragovernmental accounts to bring them into agreement with related amounts reported by its trading partners.

Attachment

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, Defense Finance and Accounting Service Indianapolis recorded $248.5 billion (excluding adjustments for intragovernmental transactions) in unsupported accounting entries to prepare the FY 2005 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 is required by generally accepted accounting principles, the systems do not always capture actual costs in a timely manner.
- Current financial processes and systems do not capture and report accumulated costs for major programs based on performance measures as required by the Government Performance and Results Act.
- DoD accounting systems do not capture trading partner data at the transaction level in a manner that facilitates trading partner aggregations. Consequently, DoD was unable to reconcile intragovernmental revenue balances with its trading partners.

Statement of Financing. Statement of Federal Financial Accounting Standards No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," states that the Statement of Financing should reconcile resources obligated during the period to the net cost of operations. However, DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making adjustments. Specifically, budgetary data are not in agreement with proprietary expenses. DoD disclosed in Note 21 that the Statements of Financing and Net Cost were adjusted by $11,378.9 million to bring them into agreement. Finally, DoD presented the Statement of Financing on a combined basis instead of a consolidated basis as required by Office of Management and Budget Circular A-136, "Financial Reporting Requirements."

Other Reportable Conditions. During FY 2005, we noted reportable conditions related to Accounts Payable, Accounts Receivable, and Contingent Legal Liabilities.

Accounts Payable. Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," states, "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 the accounts payable do not always accurately reflect the liabilities associated with the actual receipt of goods and services in the appropriate time period. Also, our reports on Internal Control for the DoD Components disclosed that some Accounts Payable were not recorded timely, unsupported adjustments were made to Accounts Payable, and supporting documentation could not be provided in a timely manner.

Accounts Receivable. Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," states "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 has acknowledged weaknesses in Accounts Receivable because policy is not always followed in relation to the recording, reporting, collecting, and reconciling of accounts receivable. Also, our reports on Internal Control for the DoD Components showed deficiencies such as inadequate audit trails and reconciliations with subsidiary records, and a general lack of controls to ensure that Accounts Receivable balances are supportable at the transaction level.

Contingent Legal Liabilities. Statement of Federal Financial Accounting Standards No. 5 requires contingent liabilities to be disclosed if there is at least a reasonable possibility that a loss may be incurred. DoD did not disclose in its legal representation letter an undetermined amount of cases that individually did not exceed the reporting threshold requested by the auditors, but in aggregate exceeded the materiality threshold. DoD and its Components had not established adequate procedures and controls to provide this information. As a result, we were unable to determine the magnitude of these potential losses. We plan to issue a separate report early in FY 2006 discussing deficiencies in the DoD process for reporting contingent legal liabilities, which will include additional information concerning this reportable condition and appropriate recommendations for correction actions.

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.

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 Federal Managers' Financial Integrity Act of 1982 and requires DoD to evaluate its systems and to annually report whether those systems are in compliance with requirements prescribed by the Comptroller General.

- The Federal Financial Management Improvement Act of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The Federal Financial Management Integrity Act 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 milestones.

For FY 2005, DoD did not fully comply with the statutory reporting requirements identified in these provisions. Specifically, DoD acknowledged that many of its critical financial management and feeder systems did not comply substantially with Federal financial management systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2005. In an attempt to remedy these long-standing financial management systems deficiencies, DoD is developing a DoD-Wide Business Enterprise Architecture. Until the architecture is fully developed and implemented, DoD will continue to be unable to fully comply with the statutory reporting requirements. We did not perform tests of compliance for these requirements.

Government Performance and Results Act. Congress enacted the Government Performance and Results Act of 1993 (The Act) 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 The Act.

DoD did not fully comply with The Act and subsequent implementation guidance in Office of Management and Budget Circular A-11, "Preparation, Submission, and Execution of the Budget." Specifically, DoD did not have a compliant strategic plan for FY 2005 because it designated the Quadrennial Defense Review report as its Government Performance and Results Act strategic plan, without consideration of The Act's requirements. In addition, the DoD performance budget and performance report for FY 2005 did not comply with The Act and Office of Management and Budget Circular A-11 because The Act strategic plan provides the framework for implementing all other parts of The Act. We plan to issue a separate report on compliance with The Act in early FY 2006 with a specific recommendation to correct this deficiency.

Antideficiency Act. Section 1341, title 31, United States Code states that a Federal employee may not "make or authorize an expenditure or obligation exceeding the amount available in an appropriation or fund for the expenditure or obligation." Additionally, 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 2005, DoD investigated 20 cases of potential violations of the Antideficiency Act and determined 15 cases to be actual violations.

Sections 1349 and 1351 of the Antideficiency Act also require DoD to immediately report the nature of violations to the President and Congress, and to take appropriate disciplinary action against those responsible for such violations. In implementing this requirement, the DoD Financial Management Regulation requires that all investigations and reports of violations be completed within one year from the date of discovery. DoD took an average 45 months to investigate and report violations. During FY 2005, DoD took an average of 16 months to identify violations of the Antideficiency Act and begin investigations. In addition, DoD Components were not consistent in disciplining personnel responsible for Antideficiency Act violations.

Prompt Payment Act. The Prompt Payment Act requires DoD to pay vendors within specified timeframes and pay interest penalties for late payments. Office of Management and Budget Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004, also requires management to develop and maintain effective internal control to ensure compliance with applicable laws and regulations. A review of invoices paid at Defense Finance and

Accounting Service Columbus during FY 2004 showed that incorrect interest payments or noncompliance with certain provisions of the Prompt Payment Act occurred for an estimated 11 percent of invoices paid. The errors occurred because DoD did not have effective systems or personnel controls in place to ensure compliance. We plan to issue a separate report on compliance with the Prompt Payment Act in early FY 2006 with specific recommendations to correct these deficiencies and improve controls.

Audit Disclosures

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us on March 21, 2005, that the DoD financial management systems cannot provide adequate evidence supporting various material amounts on the financial statements. 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 because previous audit reports contained recommendations for corrective actions, or audit projects currently in process will include appropriate recommendations.