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CFO ACT FINANCIAL AUDITS

Increased Attention Must Be Given to Preparing Navy's Financial Reports



**Accounting and Information
Management Division**

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The Honorable William J. Perry
The Secretary of DefenseThe Honorable John J. Hamre
The Under Secretary of Defense (Comptroller)The Honorable John H. Dalton
The Secretary of the NavyThe Honorable Deborah P. Christie
The Navy Assistant Secretary for Financial
Management and Comptroller

We conducted a broad-based review of various aspects of the Department of the Navy's financial management operations. We are reporting on the reliability of the Navy's fiscal year 1994 consolidated financial reports¹ so that the Navy and the Defense Finance and Accounting Service (DFAS) can

- improve the credibility of the Navy's financial reports, starting with those prepared for fiscal year 1995 and
- enhance their ability to prepare required reliable annual financial statements for the Navy, beginning with those for fiscal year 1996.

The Navy has made little progress in improving its general funds financial management and reporting since passage of the Chief Financial Officers (CFO) Act in 1990 (Public Law 101-576). Top leaders of the Department of Defense (DOD), the Navy, and DFAS must give a higher priority and instill a sense of urgency for meeting the objectives of the CFO Act in order to achieve needed improvements.

Preparing reliable financial statements is (1) key to safeguarding and effectively managing the public's substantial investment in the Navy's operations, (2) central to the Navy, DOD, and the Congress having a clear understanding of the Navy's financial condition and being able to best control costs while maintaining military readiness, and (3) critical to the reliability of the agencywide consolidated financial statements DOD is statutorily required to prepare, beginning with those for fiscal year 1996.

¹GAO reviewed the consolidated financial reports for the Navy's general funds, specifically "fund type 5" reported in accordance with the Treasury Financial Manual (1 TFM 2-4130). General funds represent the Navy's appropriation accounts established to record amounts appropriated by the Congress to fund Navy programs and operations.

The Navy, including the Marine Corps, accounts for about one-third of DOD's gross budget authority, controls almost half of DOD's assets, and employs one-third of all DOD personnel.

This report focuses on the challenges that the Navy and DFAS face to strengthen the Navy's financial management and reporting and to adequately plan for preparing auditable financial statements for the Navy within the required time frame. It also outlines recommendations for improving the Navy's and DFAS's financial management and reporting processes and internal controls. Our objective, scope, and methodology are described in appendix I. We will communicate the results of our examinations of certain other Navy financial management operations at a later time.

Results in Brief

The Navy's general fund financial reports should be a primary source of key information for effectively assessing (1) the results of its operations, (2) its stewardship over its assets, and (3) its use of budgetary resources. But, the Navy's fiscal year 1994 consolidated financial reports lacked credibility and, consequently, were of little value for these purposes. These reports, which are a measure of the Navy's ability to prepare reliable financial statements, were substantially inaccurate and indicate the need for much greater efforts than the Navy has made over the past 5 years to effectively implement the CFO Act's requirements.

We identified inaccurate financial information across the board, involving, for example, tens of billions of dollars in military equipment, inventory, and accounts receivable and payable. The Navy's fiscal year 1994 consolidated financial reports, which were submitted to the Department of the Treasury and used to prepare governmentwide financial reports, showed \$506 billion in assets, \$7 billion in liabilities, and \$87 billion in operating expenses. However, each of these amounts was substantially misstated. Overall, we identified a minimum of \$225 billion of errors in the Navy's fiscal year 1994 consolidated financial reports. These errors included:

- \$66 billion of material omissions, including \$31 billion of ammunition, \$14 billion of inventories, and \$7 billion of unfunded liabilities for projected environmental cleanup costs that were omitted altogether and
- \$43 billion of misrecorded items such as \$24 billion of structures and facilities and \$8 billion of government-furnished and contractor-acquired

material that were counted twice and \$9 billion of understated revenues due to an erroneous calculation.

The Navy's financial reports also excluded billions of dollars invested in building aircraft and missiles and modernizing of weapons systems. However, because of the poor state of Navy and DFAS financial records, we could not determine the amount of these costs and we cannot be sure that we identified all significant mistakes in the Navy's financial reports.

A root cause of the Navy's financial reporting deficiencies is the long-standing failure to use basic internal controls and to instill discipline in financial operations. The control practices used in the Navy's financial operations were fundamentally deficient: accounts and records were not routinely reconciled; periodic physical inventories of plant property were not always assured; undocumented adjustments were common; and the reasonableness of account balances, adjustments, and data presented in financial reports was not regularly reviewed.

In September 1995, the DFAS Director instructed the DFAS centers to pay closer attention to these important control areas. We hope that this instruction will set a new, positive tone for overcoming problems that have been repeatedly found in DOD's CFO Act financial audits. The Director requested the DFAS center directors to be personally involved in improving DOD's financial statements, prevent a repetition of reporting errors disclosed by DOD's CFO Act financial audits, and increase the emphasis on basic internal controls.

DOD has initiatives underway that could help address the fundamental weaknesses we found that impede effective financial management and reporting for the Navy.² The DFAS Director and the Navy Assistant Secretary for Financial Management and Comptroller will have to adequately monitor and enforce DFAS and Navy efforts to effectively implement improved financial control procedures. Better reporting on the Navy's financial operations will also require much greater emphasis than we have seen demonstrated to date on

- preparing and executing adequate financial management and reporting improvement plans;
- assessing the skills, experience, and number of financial management personnel needed; and

²Three of DOD's major initiatives are: business process reengineering, systems standardization, and consolidation of DFAS operations.

- concentrating, in the short-term, on procedures to improve existing financial systems data.

Further, it is important for the Under Secretary of Defense (Comptroller)³ to enforce the DOD policy on financial management roles and responsibilities of the Navy and DFAS as delineated in his November 15, 1995, guidance. This is necessary to effectively establish accountability for improving the Navy's financial management and reporting and preparing financial statements for the Navy in accordance with statutory requirements.

Background

The Navy comprises a very significant amount of total DOD operations. It accounted for 31 percent, or \$78 billion, of DOD's fiscal year 1994 gross budget authority; controls about 50 percent, or a reported half trillion dollars in DOD's assets, including 540 ships and over 5,200 aircraft;⁴ and employs over one million civilian and military personnel. In addition, the Navy encompasses Marine Corps operations, which in fiscal year 1994, had about \$9 billion in gross budget authority, or about 11 percent, of the Navy's gross budget authority that year. The Navy also operates certain Defense Business Operations Fund (DBOF) activities, which in fiscal year 1994 had \$24 billion in reported revenue and were larger than both the Air Force's or the Army's DBOF activities.

DOD, and especially the Navy, have acknowledged serious and long-standing financial management and reporting problems. Because of these problems, in February 1995, GAO designated DOD's financial management as a high-risk area especially vulnerable to waste, fraud, and mismanagement.⁵

Several organizations are integrally involved in carrying out the Navy's financial management and reporting: (1) the Office of the Navy's Assistant Secretary for Financial Management and Comptroller, which has overall financial responsibility, (2) DFAS, which reports to the DOD Comptroller and provides accounting and disbursing services, and (3) Navy components that initiate and authorize financial transactions. The DFAS Cleveland Center is primarily responsible for preparing the Navy's financial reports

³Hereafter in this report we refer to the Under Secretary of Defense (Comptroller) as the DOD Comptroller.

⁴As of September 30, 1994, the Navy's vessel and aircraft inventories included 342 active ships and 4,514 active aircraft.

⁵High-Risk Series, An Overview (GAO/HR-95-1, February 1995).

from data generated by accounting, financial management, and other management information systems operated by DFAS, the Navy, and the Marine Corps.

The CFO Act requires DOD and the other “CFO Act” agencies to improve their financial management and reporting operations. Among its specific requirements is that each agency CFO develop an integrated agency accounting and financial management system, including financial reporting and internal controls. Such systems are to comply with applicable principles and standards and provide for complete, reliable, consistent, and timely information that is responsive to the agency’s financial information needs. To help strengthen financial management, the CFO Act also requires that DOD prepare financial statements for its trust funds, revolving funds, and commercial activities, including those of the Navy. To test whether agencywide audited financial statements would yield additional benefits, the CFO Act also established a 3-year pilot program for the Army, the Air Force, and eight other “CFO Act” agencies or components of agencies.

In response to experiences gained under the CFO Act, the Congress concluded that agencywide financial statements contribute to cost-effective improvements in government operations. Accordingly, when the Congress passed the Government Management Reform Act of 1994 (GMRA) (Public Law 103-356), it expanded the CFO Act’s requirement for audited financial statements by requiring that all 24 “CFO Act” agencies, including DOD, annually prepare and have audited agencywide financial statements, beginning with those for fiscal year 1996. GMRA also authorizes the Director of the Office of Management and Budget (OMB) to identify component organizations of the 24 “CFO Act” agencies that will also be required to prepare financial statements for their operations and have them audited. Consistent with GMRA’s legislative history, OMB has indicated that it will identify the military services as DOD components required to prepare financial statements and have them audited. Therefore, fiscal year 1996 is the first year for which the Navy will be required to prepare a full set of financial statements for its general funds.

Widespread Weaknesses Hamper Effective Financial Management and Reporting

To an even greater extent than the other military services, the Navy is plagued by troublesome financial management problems involving billions of dollars. These problems include (1) internal control breakdowns over disbursements, (2) actual and potential violations of the Anti-Deficiency Act, and (3) widely inconsistent financial reporting on the results of operating Navy's DBOF activities.⁶ The Navy's serious and widespread financial management problems have been highlighted in audit reports, and embarrassing fraud cases and have severely impeded the Navy's effective financial management. The following are examples of these problems.

- In 1989, we reported to the Secretary of the Navy that the Navy's consolidated financial reports for fiscal year 1986 were unreliable and understated assets by \$58 billion.⁷
- In 1994, we reported a \$163 billion discrepancy between the value of property, plant, and equipment that the Navy reported for fiscal year 1993 and the amounts shown in the supporting information various Navy commands submitted to DFAS.⁸
- In its fiscal year 1994 Federal Managers' Financial Integrity Act (FMFIA) (Public Law 97-255) report to the Secretary of Defense, the Navy reported that none of the 28 operating accounting systems it evaluated complied with appropriate accounting standards and related requirements.
- Between 1989 and 1992, a former Military Sealift Command supply officer established a fictitious company, submitted over 100 bogus invoices, and received an estimated \$3 million in fraudulent payments.

With regard to internal control breakdowns over disbursements, over 2 years ago, we reported that the Navy had a severe and persistent problem with unmatched disbursements, which, in December 1992, amounted to about \$13.6 billion.⁹ As of August 31, 1995, the Navy's unmatched disbursements and other problem disbursements totaled \$18.6 billion, by far the most of any DOD component, with over 67 percent of the DOD total, as shown in table 1.¹⁰

⁶Navy DBOF activities include, for example, supply management, naval shipyards, naval aviation depots, naval ordnance facilities, public works centers, and research and development activities.

⁷Financial Reporting: Navy's 1986 Consolidated Report on Financial Position Is Unreliable (GAO/AFMD-89-18, April 6, 1989).

⁸Management letter to the Assistant Secretary of the Navy for Financial Management and Comptroller and the Director, DFAS, Cleveland Center (GAO/AIMD-94-166R, August 11, 1994).

⁹Financial Management: Navy Records Contain Billions of Dollars in Unmatched Disbursements (GAO/AFMD-93-21, June 9, 1993).

¹⁰The August 31, 1995, data was the most recent that was available at the time of our audit.

Table 1: DOD and Navy Problem Disbursements as of August 31, 1995

Dollars in billions			
Problem	DOD	Navy	Navy's portion of DOD's total (percent)
Unmatched disbursements ^a	\$11.6	\$8.0	69
Negative unliquidated obligations ^b	5.6	4.4	79
Intransit disbursements ^c	10.6	6.2	59
Total	\$27.8	\$18.6	67

^aUnmatched disbursements are disbursements that cannot be properly matched with corresponding obligations.

^bNegative unliquidated obligations are disbursements that exceed amounts of related obligations.

^cIntransit disbursements are disbursements that have been forwarded to, but not yet received or accepted by, a funding activity for matching with corresponding obligations.

Particularly troubling, the Navy continues to have difficulty in solving its problem disbursements. For example, from October 31, 1994, through June 30, 1995, the Navy and DFAS resolved about \$7.6 billion in unmatched disbursements, which is significant. This reduction was, however, largely eclipsed by \$6.7 billion in new unmatched disbursements.

Also, problems in keeping records on Navy disbursements have distorted governmentwide financial reporting. DFAS, Cleveland Center, incorrectly recorded billions of dollars of fiscal year 1995 Navy disbursements to a nonbudgetary deposit fund account. According to Department of the Treasury officials, this error resulted in the Treasury understating by at least \$4 billion the federal government's overall budget deficit reported as of June 30, 1995. Thus, maintaining accurate financial records and producing reliable financial information on the Navy's operations is a meaningful process with relevance to and significant ramifications for the government as a whole.

With respect to actual and potential violations of the Anti-Deficiency Act, for fiscal years 1993 and 1994, and through the first 10 months of fiscal year 1995, the Navy investigated 25 cases of potential Anti-Deficiency Act violations involving about \$166 million. Of these, 18 cases have been closed with the following results.

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- For 15 cases, involving about \$87 million, DOD reported to the Congress that the Navy had violated the Anti-Deficiency Act. In 11 of these cases, the violations were due to misclassifications between appropriations and four cases represented overexpenditures of obligational authority. These violations resulted in disciplinary actions against 58 people. These actions included 1 removal from office, 2 suspensions, 3 letters of punitive reprimand, 20 letters of nonpunitive reprimand, and various other admonishments.
 - In 3 cases, involving about \$63 million, investigators found no violations of the act but discovered that accounting errors primarily caused what initially appeared to have been violations.

Navy DBOF activities should operate in a businesslike manner with the objective of breaking even. However, in June 1994, we reported that, given the magnitude of differences reported for DBOF's operating results, it is difficult for Navy and DOD managers to know the Navy DBOF activities' actual operating results.¹¹ Nevertheless, the Navy has continued to report misleading DBOF financial information. For fiscal year 1994, the Navy reported (1) a loss of \$120 million in the fund's budget overview, (2) a cumulative loss of \$3.2 billion when the fund's monthly reports for the fiscal year were totaled, and (3) income of \$574 million on the fund's year-end financial statements. Thus, it is unclear and undeterminable whether, in fiscal year 1994, the Navy's DBOF activities operated at a gain or a loss, or whether they broke even as intended.

In addition to these wide fluctuations, comparison of the reported results of the Navy DBOF activities between fiscal years also shows readily apparent inconsistencies. For instance, the Navy's DBOF financial statements for fiscal year 1992 showed a \$2.7 billion operating loss whereas the fiscal year 1993 statements showed operating income of \$2.5 billion. The fiscal year 1994 statement showed operating income of \$574 million. These extreme fluctuations in annual operating results raise questions regarding the effectiveness of fund management and the accuracy of reported amounts.

In addition, the Naval Audit Service has been unable to express opinions on the Navy's consolidated DBOF activities' financial statements prepared under the CFO Act. The Service found extensive problems including that the reported cost of property, plant and equipment, and related depreciation, were not adequately supported, and account balances were

¹¹Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices (GAO/AIMD-94-132, June 22, 1994).

materially misstated.¹² Also, DFAS acknowledged in its 1994 FMFIA Statement of Assurance that its Navy-related accounting systems did not provide adequate general ledger control. As a result, the DOD Inspector General was unable to audit DOD's consolidated DBOF financial statements citing significant deficiencies in accounting systems and the inability of Navy to submit timely and accurate statements for audit of its DBOF activities.¹³

DOD has initiatives underway that could help address the fundamental weaknesses we found that impede effective financial management and reporting for the Navy. Specifically, the June 1995 DFAS Business Plan includes actions intended to achieve the finance and accounting improvement goals laid out in Secretary Perry's blueprint for financial management reform. For example, the DFAS Business Plan includes 5 actions to address DOD's problem disbursements, 19 actions to improve compliance with the Anti-Deficiency Act, and 6 actions to improve the systems supporting DOD's DBOF operations.

Financial Reports Are Grossly Inaccurate

For fiscal year 1994, the Navy's consolidated financial reports showed \$506 billion in assets, \$7 billion in liabilities, and \$87 billion in operating expenses. However, each of these amounts was substantially misstated. Overall, we identified at least \$225 billion of errors in the Navy's fiscal year 1994 consolidated financial reports. As a result, these reports were unreliable and misleading and, thus, of no use to the Congress and to DOD and Navy managers. Furthermore, the reports were, in part, prepared from budgetary data that also contained questionable and abnormal balances, such as negative unliquidated obligations.

The Navy's financial reports were submitted to the Treasury. The Treasury used data from the reports to prepare consolidated financial reports for the federal government. Therefore, the significant errors and problems we identified in the Navy's financial reports also affect the reliability of the overall government financial reports.

¹²Naval Audit Service reports include Financial Audit of the Fiscal Year 1991 Navy Industrial Fund (17X4912) Property, Plant, and Equipment Account (075-S-92, June 30, 1992); Fiscal Year 1992 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund (053-H-93, June 30, 1993); Fiscal Year 1993 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund (053-H-94, June 29, 1994); and Fiscal Year 1994 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund (044-95, May 30, 1995).

¹³DOD Office of the Inspector General Audit Report No. 95-267 Defense Business Operations Fund Consolidated Statement of Financial Position for FY 1994, June 30, 1995.

We have discussed with DOD, Navy, and DFAS officials and provided to them our workpapers documenting the errors we identified in the Navy’s reports. Nonetheless, because of the Navy’s and DFAS’s inadequate financial records, we cannot be sure that we identified all significant mistakes.

Financial Data Were Omitted, Erroneous, and Misclassified

Our analysis showed that the Navy’s fiscal year 1994 consolidated financial reports were riddled with billions of dollars in omissions, errors, and misclassifications. The effects of these misstatements on the Navy’s fiscal year 1994 consolidated Reports on Financial Position and Operations are summarized in table 2.

Table 2: Net Effects of Misstated Items on Navy’s Fiscal Year 1994 Consolidated Financial Reports

Dollars in billions			
Item	Overstated	Understated	Percent over/understated
Report on financial condition:			
Structures, facilities, and leasehold improvements	\$25.6		42
Military equipment	10.4		3
Funds with Treasury	5.8		8
Accounts payable	1.7		24
Construction in progress	.3		1
Other assets	.4		100
Inventory		\$50.9	(394)
Unfunded liabilities		8.6	(100)
Accounts receivable		.8	(39)
Payroll and benefits accrued		1.2	(100)
Nonmilitary equipment		.2	4
Equity		.5	0 ^a
Report on operations:			
Revenue from federal sources	72.0		92
Operating expenses	26.0		30
Accrued expenditures		82.6	100
Capital expenditures		27.6	100
Net results of operations		9.1	100

^aThe net effect of these misstatements is less than one-half of 1 percent.

Specifically, the Navy's fiscal year 1994 consolidated financial reports did not depict its true financial status and operating results because of:

- \$66 billion in material omissions, including \$31 billion in ammunition held worldwide; \$14 billion in supply inventories at air stations, supply centers, other shore activities, and on vessels; and \$7 billion in unfunded liabilities for projected environmental cleanup costs for which estimated costs are available;
- \$43 billion in errors, including \$32 billion in assets, such as structures and facilities, and government-furnished and contractor-acquired property that were reported twice; \$9 billion of understated revenues due to an erroneous calculation; and \$2 billion in property that were, in fact, DBOF assets, and, thus, should not have been reported in the Navy's consolidated financial reports; and
- \$116 billion in misclassifications, including \$72 billion in accrued expenditures reported as revenue; \$28 billion in capital expenditures reported as operating expenses; and \$12 billion in ammunition reported as military equipment.

Moreover, we found that the Navy's financial reports did not include billions of dollars invested in building aircraft and missiles and modernizing weapons systems. Also, while the Navy reported \$26.4 billion for ships under construction as of September 30, 1994, it did not include outfitting and post delivery costs, costs related to Military Sealift Command vessel construction, and components for future construction. The Navy did not have sufficient data from which we could determine amounts for these items.

In commenting on a draft of this report, DOD agreed that misclassifications and errors were made in the Navy's fiscal year 1994 financial reports, however, DOD stated that it could not concur with the specifics of the finding regarding the errors until it completes further research.

Required Disclosures Were Not Made

In addition, the Navy's consolidated financial reports did not disclose the government's contingent liability for potentially large losses likely to occur but for which reasonable cost estimates could not be made at the time the reports were prepared. Disclosing that these contingent liabilities exist, although they cannot be quantified at present, is significant because they could ultimately cost the government billions of dollars.

For example, the Navy's fiscal year 1994 consolidated financial reports did not describe contingent liabilities for the future costs to the government of

- cleaning up the environment at Navy sites, for which amounts were not estimable, and the Navy's share (\$643 million) of DOD's \$2 billion liability for pollution prevention activities which covers fiscal years 1995 through 1999;
- indemnifying contractors under contracts for procurement of nuclear-powered vessels, missiles, and components, and disposal of low-level nuclear waste; and
- decommissioning ships, including the disposal of nuclear propulsion plants and closing dozens of naval bases and air stations.

We found that the Navy's fiscal year 1994 consolidated financial reports did not disclose obligation and disbursement problems. First, part of the \$66 billion in material omissions previously discussed resulted because the Navy did not disclose an estimated \$888 million that will eventually be required to pay currently undelivered orders and unpaid obligations associated with appropriations that were canceled as of September 30, 1994.¹⁴ Second, the Navy did not report its billions of dollars of problem disbursements as of September 30, 1994.

Reporting of Operating Expenses and Capital Expenditures Is Unreliable

The Navy's financial systems, for the most part, do not distinguish between disbursements made for operating expenses and for capital expenditures and, thus, the amounts for these items were improperly reported. DFAS, Cleveland Center, incorrectly (1) used the total obligations incurred for all appropriations to report the Navy's operating expenses for fiscal year 1994 and (2) reported no amount for capital expenditures.

Transaction codes (specifically, object class codes), which are fundamental for properly classifying disbursements, could be used to distinguish between, and, thus, properly report, disbursements for operating expenses and capital expenditures. However, the Navy and DFAS do not require the consistent use of object class codes when recording disbursements for these purposes. OMB has recognized the importance of object class information and encourages its use for financial statement presentation under the CFO Act.

¹⁴Fixed-year appropriations are canceled 5 years after their statutory period of availability. During the 5-year period, the appropriation may be used only to pay obligations properly chargeable to its period of availability.

In this regard, we extracted approximately 174,000 disbursement transactions totaling about \$7.3 billion recorded in the Navy's Standard Accounting and Reporting System from July through September 1994. Sixty-eight percent of these transactions, representing about \$6.4 billion, did not contain object class codes. Also, we identified 2.8 million transactions processed through the Navy's Centralized Expenditure/Reimbursement Processing System for May and June 1994. We found that 2.2 million of the transactions (78 percent) were processed without object class codes.

A Navy finance official told us that Navy and DFAS activities are required to use expense element codes to record transactions for operation and maintenance and research, development, test, and evaluation appropriations, and that in his opinion, DFAS, Cleveland Center, should be able to generate expense data, at least for these appropriations, using these codes. However, similar to object class codes, our analysis of about 630,000 disbursement transactions for 2 months of fiscal year 1995 for the two appropriations showed that expense element codes were not consistently used. Of the transactions we analyzed, about 454,000 either (1) did not have expense element codes or (2) the recorded codes were invalid.

In the absence of object class and expense element code data, we believe that information from which to more accurately report these two types of disbursements could have been derived from the Navy's budget execution reports as of September 30, 1994. Using these reports, we estimated amounts for operating expense¹⁵ and capital expenditures to be \$61 billion and \$28 billion, respectively, for fiscal year 1994. As a result, we estimated that the \$87 billion that the Navy reported as operating expenses was overstated by \$26 billion, or almost 30 percent.

Lack of Basic Internal Controls and Discipline Cause Financial Reporting Problems

A root cause of the Navy's financial reporting deficiencies is the lack of basic internal controls and well-disciplined financial operations. Effective financial management requires strong systems of internal control to help ensure the integrity and reliability of financial information, safeguard assets, and promote conformity with accounting requirements and operating procedures. However, we found that the Navy and DFAS used financial control practices that were fundamentally deficient.

¹⁵To estimate operating expenses, we used budget execution reports for military personnel, reserve personnel, and operations and maintenance (which include civilian personnel costs) and research, development, test, and evaluation appropriations for both the Navy and Marine Corps.

Accounts Are Not Routinely Reconciled

Reconciliations are a primary control practice to detect differences between summary and detailed records and accounts. When independently derived records do not agree, managers are to investigate the causes, resolve discrepancies, and make appropriate adjustments. Thus, periodic reconciliations are a first-line defense to detect potential problems, such as the loss or theft of assets.

However, we found that the Navy and DFAS did not routinely perform quarterly reconciliations between (1) the Navy's official accounting records at DFAS's Defense Accounting Offices (DAO) and (2) custodial property records at Navy activities, as required by the Navy Comptroller Manual. We found, for instance, that the Navy's official accounting records at DAO-Arlington, had not been reconciled with any of the Navy's custodial property records for at least 18 months. We found unresolved differences of at least \$21 million.

Financial Reports and Trends Are Not Reviewed and Analyzed

The periodic review and analysis of financial information generated by an accounting system is a basic control technique to maintain the integrity of the information by helping to ensure that errors have not occurred. Typically, this control technique would entail processes such as (1) reviewing financial reports to detect unusual information or account balances and (2) analyzing account balance trends between reporting periods. When abnormal account balances¹⁶ or unexpected trends occur, their cause should be investigated and any necessary corrections made.

When an agency's records or reports show abnormal information or account balances, that is a strong indication that errors have occurred in recording or processing the underlying transactions. In this respect, for example, the Navy's fiscal year 1994 consolidated financial reports showed an operating loss of \$9.1 billion. This followed reported losses of \$12 billion for fiscal year 1993 and \$7.1 billion for fiscal year 1992. Taken at face value, the magnitude of these losses should have alerted the Navy that it may have overspent its appropriations during these 3 fiscal years.

Also, the financial reports DFAS used to prepare and support the Navy's consolidated financial reports for fiscal year 1994 showed various abnormal account balances, such as the following.

¹⁶Generally, account balances for specific classes of accounts will carry a normal or predictable balance. For example, asset accounts will generally carry a positive, or debit, balance.

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- The military construction appropriation report showed a negative accounts receivable balance of \$95 million.
 - The ship procurement appropriation report showed a negative accounts receivable balance of \$13 million.
 - Another procurement appropriation report showed an account balance for uncollectible receivables of \$88 million, which exceeded the reported value of receivables by \$30 million.

Although the information and account balances in each of these cases were highly unusual and unlikely to be correct, the Navy and DFAS did not investigate and correct them.

Also, we found unusual trends and large variances in account balances that were not investigated, explained, or resolved, even though the Navy's regulations require them to be. For example, the Navy's September 30, 1994, consolidated financial reports showed the value of structures and facilities to be \$62 billion, or more than double the \$29 billion reported a year earlier. A cursory review of these reports would have identified this unreasonable upward fluctuation.

Once identified, the underlying cause, which in this case was double counting, could have been readily identified and the financial reports corrected. Specifically, this double counting occurred because DFAS personnel inadvertently included in the worksheets used to prepare the Navy's fiscal year 1994 consolidated financial reports the same structures and facilities data reported from two sources—the Naval Facilities Engineering Command, which maintains Navywide real estate and facilities data, and individual Navy accounting offices.

In its comments on a draft of this report, DOD stated that Navy's SF-220 series of reports for fiscal year 1994 provided appropriation level totals but did not provide breakdowns of financial data by command or individual activity. DOD also stated that since these financial reports were prepared only at the total appropriation levels, errors at an activity or command were difficult to discern. Finally, DOD stated that it is improbable that errors at the appropriation level will be found without a breakout by command and activity data.

Effective financial systems and internal controls would prevent and/or detect errors in recording and processing transactions, regardless of the level at which they occurred. Also, it should be recognized that the fiscal year 1994 SF-220 reports which we evaluated were prepared at the overall

Navy departmental level, not at the appropriation level as the comments suggest. Contrary to the department's assertion, most of the errors we identified were not difficult to discern because they dealt with relatively obvious data omissions, double-counting, and misclassifications. In most cases, they occurred because information available at Navy commands was not requested by DFAS, Cleveland Center, errors were made in recording information in the correct "line items" of the reports, or information was entered in the reports twice.

Adequate Physical Inventories of Plant Property Were Not Assured

The Navy Comptroller Manual specifies that (1) DAOS schedule physical inventories of plant property and monitor their completion at Navy activities, (2) activities perform such physical inventories at least once every 3 years and correct their property records for any differences, and (3) activities inform the DAOS when physical inventories have been completed. However, we found that DAO-Arlington and DAO-San Diego, which accounted for \$5.2 billion of the Navy plant property reported in fiscal year 1994, did not ensure that Navy activities reporting to them had completed the required physical inventories. The activities did not properly inform the DAOS as to whether the triennial physical inventories had been completed, and the DAOS did not follow up with the activities.

Specifically, as of September 30, 1994, 124 Navy activities out of 148, or 84 percent, that DAO-Arlington had scheduled for inventories in fiscal years 1993 and 1994 had not reported to the DAO that the inventories had been completed. In February 1995, DAO-Charleston assumed plant property accounting responsibilities for these activities. As of September 30, 1995, DAO officials told us that none of the transferred activities had reported completion of their physical inventories to DAO-Charleston.

DAO-San Diego reported plant property amounts for 43 activities as of September 30, 1994. Although the plant property official at the DAO scheduled the physical inventories at these activities, the official did not check to see if the activities were reporting the completion of the physical inventories. Therefore, the DAO had no assurance that these required inventories were being done and the records corrected.

We also found that, when inventories were completed, errors were not always identified and corrected. For example, although an Air Maintenance Training Group conducted a physical inventory every 6 months, we found over \$46 million of operating inventory items inappropriately included in its plant property records. At a diving unit, our

physical inventory of equipment, which was performed shortly after the unit had completed its inventory, noted over \$1 million in errors. We also found \$1 million of discrepancies at a Naval Computer and Telecommunications Detachment when compared to the DAO-Pensacola property records for the activity.

We are now completing our review of other categories of inventory, such as operating materials and supplies, and will report later on the results of that work.

Many Adjustments Are Unsupported

There are various sound and necessary reasons for adjusting accounting records, such as to correct errors or to write off bad debts. DOD's financial management regulations require that adjustments be clearly documented to help ensure that only proper adjustments are made. Otherwise, adjustments could be used to cover up embezzlements, hide losses, or mask errors. Accordingly, it is essential to establish and enforce internal controls that (1) allow only legitimate, authorized adjustments to be made and (2) require maintenance of documentation that explains their basis and purpose, and indicates which official approved them.

However, we found that adjustments totaling billions of dollars were routinely made to accounting records and account balances, largely without adequate documentation. From October 1994 through January 1995, over \$14 billion of adjustments were processed by DFAS operating locations against the Navy's financial records. From these transactions, we judgmentally selected 64 adjustments totaling about \$1 billion and requested supporting documentation from the applicable DFAS operating locations. These locations provided us documenting records for 33, or about half, of these adjustment transactions, valued at \$498 million. For the remaining \$527 million, no documentation was provided.

Supervisory Reviews Are Not Always Performed

Supervisory review of staff work and products is a basic internal control to ensure the quality of work processes and financial reports. Without supervisory review and approval, adjustments could be used to circumvent essential internal controls and, thus, hide errors, fraud, or misuse of assets. Nonetheless, in our view, many of the inaccuracies in the Navy's financial reports discussed in the previous section could have been identified if Navy and DFAS managers had conducted adequate supervisory

reviews. Also, many of the adjustments just discussed were not provided to supervisors for their review and approval.

By using basic reasoning to assess account and report balances, evaluate changes from previous periods, and compare reported amounts with available documentation, we were able to identify numerous errors, such as the abnormal account balances and unusual trends previously discussed. The discrepancies in the financial reports and records we found were not, however, detected and investigated by either the DFAS, Cleveland Center, or the Navy.

DFAS Director Lays Groundwork to Improve Control Practices

On September 1, 1995, the DFAS Director requested that the DFAS center directors be personally involved in improving DOD's financial statements and in preventing a repetition of reporting errors disclosed by DOD's CFO Act financial audits. The Director's guidance noted that many of the errors were preventable if proper validation steps had been in place before issuance of the reports.

The DFAS Director called for increased emphasis on basic internal control areas by

- ensuring that adequate documentation is available to support the validity and accuracy of accounting transactions;
- identifying and recording accounts receivable, accounts payable, collections, and disbursements accurately, consistently, and completely, including reconciliation to supporting subsidiary ledgers;
- obtaining management approval of accounting adjusting entries;
- compiling and reporting contingent liabilities; and
- ensuring that component reports of property, equipment, and inventory are promptly submitted and certified as to accuracy.

The Director's guidance is based on DOD's lessons learned in preparing financial statements under the CFO Act and having them audited. We believe that the guidance gets to the heart of the Navy's and DFAS's financial management problems and outlines control techniques that could have detected or prevented many of the financial reporting problems we identified. The DFAS Director stressed that the guidance must be fully and effectively implemented to prevent all types of reporting deficiencies identified throughout DOD.

Financial Management Improvement Planning Is Inadequate

The Navy and DFAS, Cleveland Center, developed the joint CFO Project Plan to set out the steps necessary to meet requirements for preparing consolidated financial statements for the Navy's general fund operations for fiscal year 1996. The plan

- describes tasks to be completed, such as holding project meetings and visiting DFAS centers;
- identifies, for each task, the responsible participating organization, other participating organizations, and deliverables, such as plans or summaries; and
- includes milestones, such as planned and actual start and completion dates.

The plan, which had been under development by Navy and DFAS for approximately 6 months, was approved by the two organizations on October 4, 1995. At the time of its approval, 58 of the 204 tasks that had been identified as underway or completed as of that date were already behind schedule or not yet started. Moreover, given the scope and depth of the Navy's prior problems, we believe that the plan is not sufficiently detailed to enable the Navy and DFAS to successfully meet the requirements for the preparation of auditable financial statements within the next year. Specifically, the CFO Project Plan does not specify the:

- Specific offices or positions within the Navy and DFAS which are to be accountable for accomplishing the specific planned actions required to carry out the identified tasks. Instead, the plan identifies only organizational responsibilities for each task. For example, the plan identifies 168 tasks as the responsibility of DFAS, Cleveland Center, but does not designate a specific office or position accountable for completing the tasks.
- Actions to address previously reported deficiencies. For example, the plan calls for reviewing reports on financial operations as a discrete task with the associated deliverable specified as a summary. However, the plan does not specify the actions to be taken to deal with previously reported deficiencies identified as a result of the reviews.
- Manner in which it will be coordinated with DOD's requirement to meet governmentwide financial management improvement initiatives. These initiatives include meeting the requirements of the U.S. Standard General Ledger (SGL), which OMB has required governmentwide for almost a decade. As of September 30, 1994, OMB reported that 34 percent of all executive branch systems fully implemented the SGL and 18 percent partially implemented it. Another governmentwide financial management

initiative involves the Treasury's Federal Agencies Centralized Trial-balance System (FACTS), an automated financial reporting system using the SGL. For fiscal year 1994, the Treasury began using FACTS to collect agency standard general ledger account balances for use in producing the government's consolidated financial statements. The Treasury gave three DOD organizations and one other executive branch agency waivers for meeting this reporting requirement for fiscal year 1994.

In its comments on a draft of this report, DOD did not concur with this last finding and stated that "task 10" of the Navy/DFAS CFO Project Plan provides for coordination with the DOD FACTS effort. The cited task simply reads "Coordinate effort with FACTS effort" without providing any additional specificity. Even though it did not concur with this finding, DOD stated that the ongoing FACTS tasks will be incorporated into the Navy/DFAS plan which should resolve most of our concerns. The Navy/DFAS plan does not have any tasks specifically addressing the SGL issue.

An adequate plan would also encompass strategies to provide (1) enough financial management personnel with adequate financial management expertise and experience in Navy operations and (2) short-term solutions to improve the quality of financial data pending completion of long-term financial systems modernization plans.

Meeting Personnel Resource Needs

Navy and DFAS officials have told us on numerous occasions that they do not have enough personnel with the right experience to effectively implement the CFO Act's requirements. However, neither the Navy nor DFAS has taken steps to assess the personnel levels, skills, and experience necessary to effectively carry out Navy-related financial management responsibilities and prepare the Navy's financial reports and statements. In addition, the CFO Project Plan does not address alternatives, such as the use of contractors, for meeting Navy and DFAS financial management personnel resource needs.

An official from the Navy's Office of the Assistant Secretary for Financial Management and Comptroller told us that higher priorities, such as resolving the Navy's continuing unmatched disbursements problem, have prevented the Navy from dedicating sufficient personnel to its general fund financial reporting. Similarly, the Director of DFAS's headquarters Financial Statements Directorate stated that insufficient personnel is a primary impediment to preparing reliable financial reports on the Navy's operations.

Regarding personnel resources, we found that DFAS, Cleveland Center's Departmental Accounting and Analysis Directorate

- Had 186 authorized staff positions, but as of June 1995, 57 of these positions, or 31 percent, were vacant. Of these vacancies, 13 were at the mid- and senior-level (GS-12 and above). For generally comparable financial reporting responsibilities supporting the Air Force and the Army, DFAS, Denver Center, had 207 authorized staff positions and DFAS, Indianapolis Center, had 212 positions, with vacancy rates of about 15 percent.¹⁷
- Does not have sufficient personnel experienced in Navy operations. Before 1991, DFAS, Cleveland Center, served as the Navy's military payroll processing center. In 1991, DOD began transferring responsibility for the Navy's departmental financial reporting from the Navy's Office of the Assistant Secretary for Financial Management and Comptroller in Washington, D.C., to DFAS, Cleveland Center. Since then, only 13 personnel experienced in the Navy's financial operations, and only 3 experienced in Navy financial reporting, transferred to DFAS, Cleveland Center.
- Had 50 mid- and senior-level accountants in the 510 accounting job classification series allocated to the financial reporting area.¹⁸ This is fewer than the 60 staff in these positions at DFAS, Denver Center, and significantly fewer than the 87 at DFAS, Indianapolis Center. As of October 1995, 22 percent of DFAS, Cleveland Center's 510 mid- and senior-level staff positions were vacant.
- Had 17, or 30 percent, of its 56 mid- and senior-level positions filled with personnel in the 501 accounting-related job classification series, although this series requires no accounting education.

Ensuring that sufficient numbers of personnel with appropriate expertise are assigned financial reporting responsibilities at DFAS, Cleveland Center, is particularly important because of the deficiencies we noted in that center's financial reporting operations and the substantial effort that will be required to correct them. Consequently, an adequate financial management improvement resource plan would help ensure that the Navy and DFAS, Cleveland Center, have an adequate allocation of personnel with

¹⁷DFAS, Denver Center, which was successor to the Air Force Accounting and Finance Center, began preparing financial statements for the Air Force in 1988, and DFAS, Indianapolis Center, which was successor to the Army Finance and Accounting Center, began preparing financial statements for the Army in 1991.

¹⁸The Office of Personnel Management prescribes minimum education and experience requirements for professional positions, such as 510 accountants. The 510 accountant classification requires accounting education and/or experience.

the requisite technical skills to effectively carry out financial reporting responsibilities for the Navy.

In its comments on a draft of this report, DOD stated that DFAS, Cleveland Center, had recently received personnel resource authorizations from DFAS headquarters and that 14 accountants and financial analysts recently started work in the center's CFO area. DOD further stated that 13 more personnel were expected to join the center's CFO team by the end of February 1996. Although the hirings should logically alleviate some of the personnel shortages, a viable financial management improvement resource plan is still needed to ensure that adequate CFO technical skills are available at the center.

Improving Financial Systems

The CFO Project Plan also does not provide short-term strategies for improving existing financial systems' operations. Overall, systems deficiencies substantially increase the difficulty and time required to develop the Navy's financial reports. Further, such deficiencies significantly increase the risk of errors, and, without compensating controls, increase the Navy's and DOD's exposure to undetected fraud, waste, and mismanagement.

Both DOD and Navy officials have forthrightly acknowledged that systems deficiencies severely hamper their ability to effectively carry out accounting and financial reporting for the Navy. For example, in its fiscal year 1994 report pursuant to the Federal Managers' Financial Integrity Act, DFAS, Cleveland Center, reported that it was unable to prepare complete, reliable, and accurate financial statements because of systems deficiencies. More specifically, DFAS, Cleveland Center, reported that the nonintegrated systems it used for the Navy's financial reporting

- were not designed to conform with DOD's general ledger requirements,
- did not use the standard data elements needed to ensure consistent definition of accounts, and
- required considerable manual intervention to summarize and interpret data from subordinate systems.

The absence of a fully integrated general ledger system necessitates reliance on labor-intensive, error-prone processes to ascertain whether all required items and accounts are reported in the Navy's financial reports

and statements.¹⁹ Without integrated systems operating under general ledger control, there is no overall discipline to ensure the veracity and completeness for the amounts reported.

As a result, for example, the value of perhaps as much as 83 percent of Navy's assets—primarily property—cannot be derived from the existing financial systems structure. To report information on the dollar value of the Navy's fixed assets, the Navy and DFAS, Cleveland Center, must rely on "data calls" to various Navy commands and other organizations, which use their logistics systems and databases to provide the information.

DOD began its Corporate Information Management (CIM) initiative in 1989 with the objective of improving its business processes and information systems. With respect to accounting and finance systems, DFAS's approach to implementing the CIM concept has been to select and adapt as an interim step the best existing systems for use as "migratory" financial systems to be followed eventually by "target" systems. Most recently, DFAS has set out its strategy for consolidating DOD's accounting systems as part of the July 1995 DFAS Business Plan.

Although the DFAS strategy calls for systems improvements, few, if any, improvements have been made in the systems the Navy or the other military services, will use for financial management and reporting. Historically, DOD's system improvement plans have fallen far short of goals and its continuing systems problems are a serious challenge that will require a number of years to correct.

In the short term, many Navy and DFAS financial management problems can be successfully remedied without developing new systems. In this regard, it is imperative that the Navy and DFAS make concerted efforts now to improve the data produced by their existing systems. Consequently, an adequate CFO Project Plan would address the specific actions that both the Navy and DFAS will take to (1) improve data in existing systems, (2) ensure the use of existing systems' capabilities to account for transactions by object class or expense element, and (3) follow existing systems' operating and transaction processing requirements. It will also be important to have procedures to monitor throughout the year whether rudimentary controls, such as those the DFAS Director called for in September 1995, are being used throughout Navy and DFAS financial operations.

¹⁹An integrated general ledger system is a single system, supported by subsidiary systems, to provide the control necessary to ensure all financial data are accurately recorded and summarized.

In commenting on a draft of this report, DOD stated that the Standard Accounting and Reporting System-Departmental Reporting (STARS-DR) (a system currently under development) has been designated as the “target” system for Navy’s general fund financial reporting. It remains to be demonstrated whether STARS-DR, once developed and implemented, will adequately serve as the Navy’s overall financial reporting system. We would also note that many of the problems we identified resulted from Navy and/or DFAS personnel not following established procedures, a condition that would detrimentally affect data in even the most well-designed and implemented systems.

Recently-Issued DOD Policy Intended to Clarify Accountability for Financial Management and Reporting

In the past, DOD has not clearly defined or strictly enforced accountability between the Navy and DFAS for the Navy’s financial management and reporting operations and for meeting the CFO Act’s requirements. On November 15, 1995, the DOD Comptroller issued a departmentwide policy, “Roles and Responsibilities of the DOD Component and the Defense Finance and Accounting Service Relative to Finance and Accounting Operations and Departmental Reports.”

The policy, for example, requires DFAS to

- perform quality control reviews of the financial reports and statements it prepares;
- furnish these documents to its “customers” for review and concurrence before release;
- obtain preapproval from “customers” for any prior period adjustments to their financial reports that exceed established thresholds;
- adequately and properly document all adjustments, including appropriate documentation to support the need to correct an error and adjust the affected balances; and
- report potential violations of the Anti-Deficiency Act to the cognizant military service or other DOD component.

Similarly, the policy mandates specific responsibilities for data accuracy to the DOD components, such as the military services, for which DFAS prepares financial statements. This policy establishes specific requirements for the components with respect to such things as (1) installing and operating appropriate internal controls to help ensure the accuracy of data provided to DFAS and (2) assessing the quality of information in DFAS-prepared reports prior to their release.

If effectively implemented, the policy, along with the DFAS Director's September 1995 guidance, should help to resolve many of the reporting problems we found involving the Navy and DFAS. However, the policy generally does not impose new requirements, as many of the provisions were already required by DOD regulations prior to the Comptroller's issuance of the guidance. Further, neither DFAS nor the military services have consistently followed required procedures. We found no evidence that failure to follow established procedures resulted in disciplinary or other adverse actions except in instances also involving violations of laws.

Consequently, to make the present arrangement work more effectively, the policy must be expeditiously and fully implemented so that the Navy's and DFAS's specific financial management roles and responsibilities are clearly delineated. To follow through and determine whether all provisions of the new policy are enforced and effectively implemented, or whether refinements are necessary, it is important for the DOD Comptroller to

- establish time frames within which to achieve results from the clarified roles and responsibilities, and establish milestones for assessing progress toward financial management improvement;
- designate specific offices or positions to be held accountable for actions to improve the Navy's financial management and reports; and
- discipline managers for failing to improve the Navy's financial management operations and to meet the CFO Act's requirements to enhance financial systems.

In its comments on a draft of this report, DOD stated that it was concerned that our finding tends to underplay the importance of the DOD Comptroller's November 15, 1995, "roles and responsibility" document by stating that the document generally does not impose new requirements, as many of the provisions were already required by DOD regulations. DOD further stated that, prior to the Comptroller's guidance, it was not always clearly stated whether DFAS or DOD components were responsible for specific financial management and reporting requirements. Finally, DOD stated that, due to various accounting and finance consolidations, DFAS's roles and responsibilities relative to its customers were not formalized and therefore, were not clear to all parties.

The need to clarify the respective roles and responsibilities of DFAS and the military services has existed since DFAS began operations in 1991. In August 1992, we first reported that DOD needed to clearly define DFAS's role

and accountability for financial management and reporting.²⁰ While the DOD Comptroller's November 1995 guidance clarifies the roles and responsibilities of DFAS and the DOD components, it does not greatly change existing financial management requirements, such as properly documenting transactions, accurately and completely processing transactions in a timely manner, and establishing appropriate internal controls. These and many more requirements existed prior to the Comptroller's guidance. We recognize that the guidance now fulfills the need to more clearly define whether DFAS or DOD components are responsible for implementing the various requirements. The guidance should provide a vehicle to begin holding the appropriate DFAS and military service officials accountable for meeting those requirements.

Conclusions

The serious financial management and reporting problems we found place the Navy at significant risk of waste, fraud, and misappropriation and drain resources needed for military readiness. We found widespread financial reporting inaccuracies, involving billions of dollars in erroneous balances covering the spectrum of key accounts. These inaccuracies undermine the credibility of financial reports and information on the Navy's operations available to the Congress and Navy and DOD managers. Equally disturbing, the Navy's financial reports mask various problems with data, including abnormal budgetary account balances, used to prepare these reports.

Our work showed little tangible progress toward resolving the Navy's financial management problems. The pervasive financial management problems we identified involve both the Navy and DFAS and stem primarily from these organizations not adequately

- observing basic accounting and control conventions;
- implementing financial management improvement efforts to achieve accurate reporting;
- addressing serious financial management staffing shortfalls;
- using existing systems to their full potential in controlling, managing, and reporting on the Navy's financial operations; and
- exercising effective financial management accountability in the current arrangement of shared responsibility between DFAS and the Navy.

²⁰Financial Management: Immediate Actions Needed to Improve Army Financial Operations and Controls (GAO/AFMD-92-82, August 7, 1992).

The Navy and DFAS have had several years to address the pervasive and long-standing problems that hamper the Navy's financial management operations, and, as the CFO Act requires, to begin readying themselves to prepare reliable financial statements for the Navy for fiscal year 1996. The Navy has not taken advantage of the 5 years since the act's passage, or the lessons learned from the experiences of its counterparts, the Army and the Air Force, in preparing financial statements. The Navy and DFAS must now "catch up" through measures that will lead to successfully preparing reliable financial statements on the Navy's operations within the next year or so.

The DFAS Director has set the underpinnings for improved financial controls. This groundwork is an important step in finally coming to grips with a long record of neglect, underscored by the lack of accounting discipline and of a perceived value in this function. As a key "CFO Act" agency, it is imperative for DOD to now ensure that the difficulties the Navy and DFAS have experienced in preparing reliable Navy financial reports do not prevent DOD from meeting its statutory responsibility to prepare reliable agencywide financial statements beginning with those for fiscal year 1996.

Recommendations

We recommend that the DOD Comptroller and the Navy's Assistant Secretary for Financial Management and Comptroller

- jointly act to improve the credibility of the Navy's financial reports and to adequately position the Navy and DFAS to prepare auditable financial statements for the Navy, beginning with those for fiscal year 1996, and
- periodically report to the Secretary of Defense the status of their results.

First, to avoid the mistakes made in preparing the Navy's fiscal year 1994 consolidated financial reports, the Navy and DFAS should diligently attain the greatest degree of accuracy possible in finalizing the Navy's fiscal year 1995 consolidated financial reports. This is especially critical because data in these reports will help establish the opening balances for fiscal year 1996. These actions would, at minimum, require that

- financial statements and reports be compiled in accordance with applicable Treasury, OMB, and DOD requirements;
- financial information be reviewed thoroughly to determine its reasonableness, accuracy, and completeness;

-
- adjustments to account balances and reports be fully documented as to their basis and purpose; and
 - the Assistant Secretary of the Navy for Financial Management and Comptroller certify that financial reports comply with applicable requirements.

Second, so that fiscal year 1996 and subsequent financial statements for Navy operations are auditable, the Navy and DFAS should place high priority on implementing basic required financial controls over Navy financial accounts and reports. The minimum requirements to carry out this step would include assurance that

- Navy's periodic physical inventories of equipment, property, and inventories are taken, the results are reported to DFAS, and any discrepancies are investigated as to cause and resolved;
- reconciliations of accounts and records are made, significant discrepancies are examined and resolved, and appropriate adjustments are made;
- transactions are clearly and completely documented and such documentation is retained and readily available to support account balances; and
- account balances are analyzed and financial reports are reviewed to detect abnormal account balances and unusual fluctuations and trends, any significant variances are researched and are explainable, and any necessary corrections are made.

Also, to ensure that these basic internal control requirements are enforced, the Navy and DFAS should develop and implement strategies for monitoring progress throughout the year.

Third, the Navy and DFAS should immediately prepare implementing strategies for producing reliable financial statements for the Navy, beginning with those for fiscal year 1996. This plan should, at a minimum

- address staffing issues, such as filling financial management vacancies, upgrading the experience of financial managers, and using contractors, as necessary, to improve financial management operations;
- include short-term measures to improve the data in existing financial systems, follow existing systems operating and transaction processing requirements, and use standard data elements, such as object class codes;

- incorporate strategies for promptly meeting DOD's requirement to use the U.S. Standard General Ledger and the Treasury's Federal Agencies Centralized Trial Balance System; and
- identify the specific offices or positions accountable for accomplishing the actions established by the strategies and provide a means for monitoring implementation throughout the year.

Finally, given the history of problems in preparing the Navy's financial reports, we recommend that the DOD Comptroller's November 15, 1995, policy on roles and responsibilities of DOD components and DFAS be supplemented with

- strategies to hold organizations and individuals accountable for effectively carrying them out,
- milestones for monitoring implementation progress during the year, and
- periodic assessments during annual financial reporting cycles to ensure that the roles and responsibilities are continually enforced.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD generally concurred with our findings and recommendations. However, DOD maintained that both DFAS and the Navy have taken and are continuing to take enormous strides in meeting the requirements of the CFO Act and GMRA. DOD stated that while, ideally, faster progress may be desirable, the significant progress that the department believes it has made since 1990 should be recognized. DOD stated that actions underway to better position it for the future, such as the financial management reform initiatives to improve processes and major reorganizations to reduce resources, should also be recognized. DOD further stated that it would be inaccurate to state that the Navy has made little progress in improving its financial management and reporting since passage of the CFO Act. DOD cited the progress made by the Navy in improving financial reporting for its DBOF activities and trust funds while recognizing that the Navy has not had to previously prepare financial statements for its general fund operations.

This report acknowledges that the Navy has not previously been required to prepare financial statements for its general funds and that fiscal year 1996 is the first year for which the Navy will be required to prepare such statements. As a result, we focused our work on the required Treasury reports, not the more extensive financial statements required by the CFO Act, as expanded by the GMRA. Navy's and DFAS's inability to accurately prepare the less-comprehensive financial reports and the extent of the

problems and deficiencies we identified with those reports is the focus of this report and raises serious questions regarding Navy's and DFAS's commitment and ability to prepare the fiscal year 1996 financial statements, which, for the most part, will be based on the same data sources.

We state in our report that DOD has begun departmentwide initiatives that could help address the fundamental weaknesses we found in the Navy's general fund financial management and reporting. However, our review showed that severe deficiencies, including billions of dollars in problem disbursements, grossly inaccurate and unreliable financial reports, and significant internal control breakdowns, pervade the Navy's general fund financial operations. As a result, a great deal more progress must be achieved by the Navy and DFAS to meet the requirements of the CFO Act and prepare reliable financial statements by the date stipulated in law. Considering the enormity of the problems and deficiencies to be overcome, the progress made to date by the Navy and DFAS in the Navy's general funds is relatively small and, in our view, warrants our finding that little progress has been made.

DOD fully concurred with 16 of our recommendations and partially concurred with 2 others. First, DOD partially concurred with our recommendation that the Assistant Secretary of the Navy for Financial Management and Comptroller certify that the Navy's financial reports comply with applicable requirements. DOD stated that the annual Navy financial statements prepared pursuant to the CFO Act are required to be accompanied by a management representation letter signed by the Secretary of the Navy or the Under Secretary of the Navy. In DOD's view, the management representation letter is the appropriate medium to provide management comments on financial statements. With respect to our recommendation, we agree that management representation letters are an appropriate medium for certification of financial statements and, therefore, if properly used, should fulfill the intent of our recommendation. The letters should acknowledge management's responsibility for the fair presentation of information in the accompanying financial statements. However, in instances where management has concerns regarding the viability of its financial statements, management representation letters should be used to highlight and communicate those concerns to the statements' auditors.

Second, DOD partially concurred with our recommendation that the Navy and DFAS identify the specific offices or positions accountable for

accomplishing actions established by strategies for preparing the Navy's financial statements and monitoring progress throughout the year. Although DOD did not fully concur with the recommendation, its intended action—revising the Navy and DFAS CFO Project Plan to indicate participating organizations and responsible elements within those organizations—fulfills the intent of our recommendation. Once the participating organizations and responsible elements are identified, it is important that the Navy and DFAS monitor the progress of those organizations and elements to ensure that planned actions are effectively carried out within established milestones.

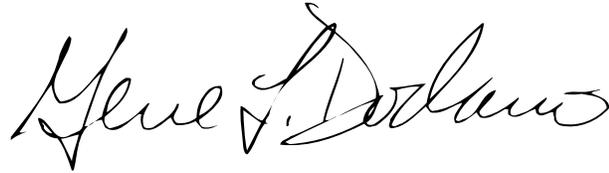
DOD, for the most part, agreed with our findings in this report although it partially concurred with several findings and disputed the facts in one case. We have evaluated and addressed DOD's comments to the extent necessary in the appropriate sections of this report.

The full text of DOD's comments is provided in appendix II.

We are sending copies of this report to the Chairmen and the Ranking Minority Members of the Senate and House Committees on Appropriations, Subcommittees on Defense; the Senate Committee on Armed Services and its Subcommittee on Readiness; the Senate Committee on Governmental Affairs; and the House Committee on Government Reform and Oversight as well as its Subcommittee on Government Management, Information, and Technology. We are also sending copies to the Director of the Defense Finance and Accounting Service, the Secretary of the Treasury, and the Director of the Office of Management and Budget. We will make copies available to others upon request.

The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight within 60 days of the date of this report. You must also send a written statement to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this report.

If you have questions regarding this report, please call Lisa G. Jacobson, Director, Defense Financial Audits, at (202) 512-9095, or Gerald W. Thomas, Assistant Director, Defense Financial Audits, at (202) 512-8841.

A handwritten signature in black ink, reading "Gene L. Dodaro". The signature is written in a cursive style with a large, stylized initial "G".

Gene L. Dodaro
Assistant Comptroller General

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Abbreviations

CFO	Chief Financial Officers
CIM	Corporate Information Management
DAO	Defense Accounting Office
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DOD	Department of Defense
FACTS	Federal Agencies Centralized Trial-balance System
FMFIA	Federal Managers' Financial Integrity Act
GAO	General Accounting Office
GMRA	Government Management Reform Act of 1994
OMB	Office of Management and Budget
STARS-DR	Standard Accounting and Reporting System-Departmental Reporting
SGL	U.S. Standard General Ledger

Objective, Scope, and Methodology

Our objective was to determine the Navy's readiness to prepare reliable financial statements for fiscal year 1996. We examined

- the overall reliability of the Navy's fiscal year 1994 financial reports, and the adequacy of the processes and controls the Navy and DFAS used to prepare them;
- the adequacy of the Navy's and DFAS's financial management planning, staffing, and systems; and
- the effectiveness of accountability for ensuring the reliability of the Navy's financial reporting.

We examined the Navy's fiscal year 1994 financial reports (the Treasury "SF-220" series) because (1) the information for these reports was derived from the sources the Navy and DFAS would, for the most part, use to prepare statutorily required financial statements and (2) the reliability of the fiscal year-end accounts balances used to prepare these reports is integral to the Navy's accurately establishing the ending account balances for fiscal year-end 1995 and, consequently, beginning balances for fiscal year 1996. Inaccurate beginning account balances would affect the reliability of the Navy's fiscal year 1996 financial statements. We have not, however, audited the Navy's fiscal year 1994 financial reports and, therefore, express no opinion on them.

To assess the overall reliability of the Navy's financial reports we

- evaluated whether the reported data were logical and presented in accordance with Treasury, DOD, and Navy guidance and requirements;
- verified the mathematical accuracy of reported amounts; and
- traced reported amounts to available supporting documentation and reports at DFAS, Cleveland Center.

In making our assessment, we considered the Navy's previously reported financial management problems. We identified these problems from our prior audit reports and those of the DOD Inspector General and the Naval Audit Service and determined whether the problems continued. We also examined DOD and Navy reports of internal control and accounting systems weaknesses based on self-assessments made under the Federal Managers' Financial Integrity Act of 1982.

To examine the adequacy of the Navy and DFAS financial reporting processes and controls, we identified and reviewed pertinent financial management policies and procedures that the Navy and DFAS had in place.

We also observed whether these processes and controls were working as the Navy and DFAS intended, and tested selected transactions affecting reported account balances. We also reviewed applicable Treasury, OMB, and DOD guidance and requirements for reporting financial transactions and preparing financial reports.

To determine the adequacy of Navy financial management planning, staffing, and systems, we

- discussed with Navy and DFAS officials current plans and strategies for preparing the Navy's financial statements for fiscal year 1996. We analyzed available documents relating to these plans and focused on whether they adequately (1) addressed the types of deficiencies we noted in assessing the Navy's fiscal year 1994 financial reports and (2) supported meeting the statutory time frame for preparing financial statements.
- discussed financial reporting staffing issues with Navy and DFAS, Cleveland Center, officials. We also identified DFAS, Cleveland Center's financial reporting staff level and experience, and compared them with the financial reporting staff levels and experience of other DFAS centers.
- identified and reviewed previously reported Navy and DFAS financial management systems deficiencies and financial systems modernization plans.

To examine the organizational accountability established to ensure the reliability of the Navy's financial reporting, we determined the financial management lines of authority and responsibility established by the Navy, DFAS, and DOD. In addition, we identified previously reported DOD problems in these areas, and discussed with DOD and Navy officials the current status of efforts to resolve them. We also obtained and analyzed a proposed new DOD Comptroller policy, Roles and Responsibilities of DFAS and Other DOD Components, and a draft DOD financial management regulation, "Reporting Policies and Procedures."

In a briefing on November 17, 1994, we advised the Assistant Secretary of the Navy for Financial Management and Comptroller and key DOD financial management officials on the preliminary results of our review. On April 20, 1995, we briefed the Director of the DFAS, Cleveland Center, and senior officials from the Navy Comptroller's Office. During both meetings, we made suggestions for correcting financial management and reporting problems hindering the Navy's development of reliable financial statements for future fiscal years.

Appendix I
Objective, Scope, and Methodology

In addition to the adequacy of the Navy's financial reporting, which is the subject of this report, we are also evaluating certain other aspects of the Navy's financial management operations. We will report later on these areas.

We conducted our work primarily at Navy and DFAS Headquarters in Washington, D.C., and at DFAS, Cleveland Center. Our work was performed from August 1993 through October 1995 in accordance with generally accepted government auditing standards.

Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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FEB - 9 1996

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Dodaro:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "CFO ACT FINANCIAL AUDITS: Increased Attention Must Be Given To Preparing Reliable Financial Information On Navy's General Fund Operations," dated November 8, 1995 (GAO Code 918813), OSD Case 1050. Although the Department generally concurs with many of the findings and recommendations in the report, comments are being provided to improve the accuracy and completeness of the draft.

In general, while the GAO draft report notes deficiencies in financial information, the report fails to fully convey the enormous strides that both the Defense Finance and Accounting Service (DFAS) and the Department of the Navy have taken, and are continuing to take, in meeting the requirements of the Chief Financial Officer (CFO) Act of 1990 and the Government Management Reform Act of 1994.

The Defense Finance and Accounting Service (DFAS), which has been in existence only since January 1991, has been successfully dealing with possibly the most massive finance and accounting consolidation effort ever undertaken. Previous to the DFAS, each Military Service and many Defense Agencies performed finance and accounting functions independently. Now, as a result of the consolidation, the number of sites performing finance and accounting functions in the United States is in the process of being reduced from over 300 to 26. Due in part to the ongoing consolidation efforts, the roles and responsibilities of the DFAS and its customers were not formalized and acknowledged by all parties until recently. Nevertheless, the Director of the DFAS, as noted twice in the draft report, personally directed the initiative toward improving financial reporting under his charge and solicited the personal involvement of the DFAS Center Directors in this effort.

On November 15, 1995, the Under Secretary of Defense (Comptroller) approved specific roles and responsibilities of the DoD Components and the DFAS relative to finance and accounting operations and Departmental reports. This roles and responsibilities guidance should satisfy several accountability issues raised in the audit.

See comment 1.

Discussed on pp. 29-30.

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Discussed on pp. 29-30.

While, ideally, faster progress may be desirable; the significant progress the Department has made since 1990 should be recognized. Additionally, actions underway to better position DoD for the future, such as DoD's financial management reform initiatives to improve processes and major reorganizations to reduce resources, should also be recognized.

The DoD believes that it would be inaccurate to state that the Navy has made little progress in improving its financial management and reporting since passage of the CFO Act of 1990. The Navy has not been required to submit and, therefore, has not prepared, financial statements pursuant to the CFO Act of 1990 for its general (appropriated) funds. However, since FY 1993, the Navy has submitted CFO financial statements for the Defense Business Operations Fund (DBOF) activities and the Navy trust funds. Each year, these DBOF and trust fund financial reports for the Navy have improved considerably due to the combined work of the DFAS and the Navy. Although problems remain, there has been major progress. A Naval Audit report of October 12, 1995, "Trends in Management's Responses to Financial Audits," states that positive trends in financial statement reporting and presentation demonstrate the Navy's commitment to improve financial management and to comply with the CFO Act of 1990 and the Government Management Reform Act of 1994.

In summary, the Department is placing high level attention on fixing deficiencies in its current financial systems; however, attaining full compliance with the Chief Financial Officers Act will take considerable time, money and effort.

The Department appreciates the opportunity to comment on the draft report. Detailed comments to the findings and recommendations are enclosed.

Sincerely,


for Alvin Tucker
Deputy Chief Financial Officer

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GAO DRAFT REPORT - DATED NOVEMBER 8, 1995
OSD CASE 1050, GAO CODE 918813

"CFO ACT FINANCIAL AUDITS: INCREASED ATTENTION
MUST BE GIVEN TO PREPARING RELIABLE FINANCIAL
INFORMATION ON NAVY'S GENERAL FUND OPERATIONS"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

FINDING A: Widespread Weaknesses Hamper Effective Financial Management and Reporting. The GAO stated that the Navy is plagued by troublesome financial management problems including (1) internal control breakdowns over disbursements, (2) actual and potential violations of the Anti-Deficiency Act, and (3) widely inconsistent financial reporting on the results of operating the Navy Defense Business Operations Fund (DBOF) activities. With regard to internal control breakdowns over disbursements, the GAO reported that the Navy continues to have difficulty in solving its problem disbursements. The GAO noted that between October 31, 1994, and June 30, 1995, the Navy and the Defense Finance and Accounting Service (DFAS) resolved about \$7.6 billion in unmatched disbursements, but the reduction was eclipsed by \$6.7 billion in new unmatched disbursements.

The GAO stated that problems in keeping records on the Navy disbursements have distorted government-wide financial reporting. The GAO noted that the DFAS, Cleveland Center, incorrectly recorded billions of dollars of FY 1995 Navy disbursements to a non-budgetary deposit fund account. The GAO reported that Department of the Treasury officials indicated this error resulted in the Treasury understating by at least \$4 billion the Federal Government's overall budget deficit reported as of June 30, 1995.

With respect to actual and potential violations of the Anti-Deficiency Act, for FY 1993 and FY 1994, and through the first 10 months of FY 1995, the GAO found that the Navy investigated 25 cases of potential Anti-Deficiency Act violations involving about \$166 million. The GAO also found that the Navy has continued to report misleading DBOF financial information, and it is unclear and indeterminable whether, in FY 1994, the Navy DBOF activities operated at a gain or a loss, or whether they broke even as intended.

The GAO concluded that the DoD initiatives underway, such as the June 1995 DFAS Business Plan, could help address the fundamental weaknesses that impede effective financial management and reporting for the Navy, and achieve the finance and accounting improvement goals laid out in Secretary Perry's blueprint for financial management reform. (p. 3, pp. 8-14/GAO Draft Report)

DOD RESPONSE: Concur. However to present a more complete picture, the finding also should recognize more of the positive steps taken through the joint efforts of the Department of the Navy and the DFAS. In addition to the business process reengineering, system

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Now on pp. 2, 6-9.

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standardization, and consolidation of operations financial management reform initiatives described in the forwarding letter for this attachment; many other improvements have been made and progress has been achieved. For example:

- The Navy and the DFAS already have begun to prepare command and field financial managers for the CFO submission for FY 1996. Conferences were held in March and November 1995 to inform Department of the Navy personnel on CFO reporting responsibilities.
- The Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) [OASN(FM&C)] reorganized to be more responsive to the CFO Act and implemented new managerial processes to review financial statements prepared by the DFAS.
- In July 1995, the Department began a process to pre-validate payment requests to obligations in the accounting systems prior to payment. This pre-payment validation, starting for payment requests greater than \$5 million, should reduce unmatched disbursements. To assist in the pre-validation, the DFAS is modifying its accounting and payment systems to fully automate the pre-payment matching process. In addition, the DFAS, together with the Navy, has implemented automated data base comparison programs to identify data discrepancies between the payment system records and the accounting system records. Identified discrepancies are being researched and resolved. It is data differences between the two systems that cause many of the unmatched disbursements.

FINDING B: Financial Reports Are Grossly Inaccurate. The GAO identified inaccurate financial information across the board involving billions of dollars in military equipment, inventory, and accounts receivable and payable. The GAO reported the Navy consolidated financial reports for FY 1994 showed \$506 billion in assets, \$7 billion in liabilities, and \$87 billion in operating expenses. The GAO found, however, that each of these amounts was substantially misstated. The GAO identified at least \$225 billion of errors, including \$66 billion of material omissions, \$43 billion of misrecorded items (such as assets counted twice), and \$116 billion of misclassifications. In addition, the GAO found the Navy financial reports did not include billions of dollars invested in building aircraft and missiles and modernizing weapons systems. The GAO concluded that these reports were unreliable and misleading and, thus, of no use to the Congress, the DoD, or the Navy managers. In addition, the GAO discovered that the Navy consolidated financial reports did not disclose the Government contingent liability for potentially large losses likely to occur but for which reasonable cost estimates could not be made at the time the reports were prepared.

The GAO also determined that the Navy financial systems, for the most part, do not distinguish between disbursements made for operating expenses and for capital expenditures. The GAO reported that the Navy and the DFAS do not require the consistent use of object class codes when recording disbursements for these purposes. In the absence of object class and expense element code data, the GAO estimated operating expense and capital expenditures to be \$61 billion and \$28 billion, respectively, for FY 1994. As a result, the GAO estimated that the \$87 billion that the Navy reported as operating expenses was overstated by \$26 billion, or almost 30 percent. (p. 3, pp. 15-21/GAO Draft Report)

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See comment 2.

Now on pp. 2-3, 9-13.

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Discussed on p. 11.

DOD RESPONSE: Partially concur. While the Department agrees that misclassifications and errors have been made; the Department cannot concur in the specifics of this finding until it completes further research.

FINDING C: Lack of Basic Internal Controls and Discipline Cause Financial Reporting Problems. The GAO determined that the lack of basic internal controls and well-disciplined financial operations is a root cause of the Navy financial reporting deficiencies. The GAO found that the Navy and the DFAS used financial control practices that were fundamentally deficient. In addition, the GAO stated that (1) accounts and records were not routinely reconciled, (2) periodic physical inventories of plant property were not always assured, (3) undocumented adjustments were common, and (4) the reasonableness of account balances, adjustments, and data presented in financial reports was not regularly reviewed.

The GAO concluded that many of the inaccuracies in the Navy financial reports could have been identified if the Navy and the DFAS managers had conducted adequate supervisory reviews. The GAO stated the September 1, 1995, DFAS Director guidance to the DFAS center directors gets to the heart of the Navy and the DFAS financial management problems and outlines control techniques that could have detected or prevented many of the financial reporting problems identified by the GAO. (p. 4, pp. 21-30/GAO Draft Report)

Now on pp. 3, 13-18.

Discussed on p. 15.

DOD RESPONSE: Partially concur. The SF 220 Series of financial statements produced for FY 1994 provided appropriation level totals but did not provide a breakdown of financial data by command or individual activity. Since these financial statements were prepared only at the total appropriation level, errors at an activity or command were difficult to discern. Generally, it is improbable that errors at the appropriation level will be found without a breakout by command and activity data.

FINDING D: Financial Management Improvement Planning Is Inadequate. The GAO found that the Navy and the DFAS, Cleveland Center approved, as of October 4, 1995, the joint CFO Project Plan to set out the steps necessary to meet requirements for preparing consolidated financial statements for the Navy's general fund operations for FY 1996. The GAO noted that the plan showed 58 of the 204 tasks that had been identified as under way or completed as of the plan's approval date were already behind schedule or not yet started. Specifically, the GAO stated the CFO Project Plan does not specify the (1) specific offices or parties within the Navy and the DFAS who are to be accountable for accomplishing the specific planned actions required, (2) actions to address previously reported deficiencies, and (3) manner in which it will be coordinated with DoD's requirement to meet government-wide financial management improvement initiatives such as the U.S. Standard General Ledger and the Federal Agencies' Centralized Trial-balance System (FACTS). (p. 4, pp. 30-33/GAO Draft Report)

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DOD RESPONSE: Partially concur. As noted by the GAO, the CFO FY 1996 Project Plan was approved by the Navy and accepted by the DFAS on October 4, 1995. This management tool will be used to accomplish the FY 1996 Navy CFO reporting requirements. The Plan includes detail taskings but allows changes as needed to accomplish the FY 1996 financial reporting. The Plan will be updated monthly to include modifications made to it during the month. The following are comments to specific GAO concerns:

GAO concern (1): The CFO Project Plan does not specify the offices or positions within the Navy and the DFAS who are to be accountable for accomplishing the specific planned actions required.

Comment: Concur. The overall execution of the CFO Project plan is the responsibility of the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) [OASN(FM&C)] and the DFAS. Although the Plan initially did not designate an office or position by name, it will be revised to indicate participating organizations and responsible elements within those organizations.

GAO concern (2): The CFO Project Plan does not specify the actions to address previously reported deficiencies:

Comment: Concur. Although the CFO Project Plan addresses previously reported deficiencies in general, it will be revised to address specific deficiencies. The 1995 Statement of Assurance prepared by the DFAS-CL includes an analysis of systems deficiencies and problems and will be used to guide efforts in this area as part of the CFO Project Plan.

GAO concern (3): The CFO Project Plan does not specify the manner in which it will be coordinated with DoD's requirement to meet government-wide financial management improvement initiatives.

Comment: Nonconcur. Although the GAO states that the CFO Project Plan does not address the issues of the U.S. Standard General Ledger and FACTS, it does. Task 10 of the CFO plan specifically states that the team will coordinate its effort with the FACTS effort. The DFAS requires the development of separate plans of action and milestones for CFO reporting, FACTS, and interim migratory systems projects, and maintains periodic updates. It should be noted that the DFAS-CL has successfully prepared Treasury Index 97 FACTS Adjusted Trial Balances in the Standard General Ledger format. Nevertheless, to help achieve clarity and to demonstrate DoD's commitment to consider closely and monitor projects that impact on the CFO effort, the ongoing FACTS tasks will be incorporated into the overall CFO Project Plan.

FINDING E: Meeting Personnel Resource Needs. The GAO reported that Navy and DFAS officials advised on numerous occasions that they do not have enough personnel with the right experience to effectively implement the CFO Act requirements. The GAO noted that neither the Navy nor the DFAS has taken steps to assess the personnel levels, skills, and experience necessary to effectively carry out Navy-related financial management responsibilities and prepare the Navy

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Discussed on p. 20.

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financial reports and statements. In addition, the GAO reported the CFO Project Plan does not address alternatives, such as the use of contractors, for meeting the Navy and the DFAS financial management personnel resource needs. According to the GAO, a Navy financial management official advised that higher priorities, such as resolving the Navy continuing unmatched disbursements problem, have prevented the Navy from dedicating sufficient personnel to its general fund financial reporting. (p. 5, pp. 33-35/GAO Draft Report)

Discussed on p. 22.

DOD RESPONSE: Concur. Although additional personnel are desirable, the Department of the Navy is under severe personnel constraints and does not have the funding to hire the additional personnel necessary to accomplish, manually, the additional actions recommended by the GAO. The DFAS has taken steps to assess DFAS-CL personnel needs. DFAS-CL recently received resource authorizations from DFAS-HQ to meet their CFO personnel needs. Fourteen new accountants and financial analysts have recently started work in the authorized positions and recruitment continues. DFAS-CL is bringing new staff on as they become available and at least six new accountants are expected to join the DFAS-CL CFO team in early February 1996 with an additional seven by the end of February.

Additionally, while the CFO Project Plan may not specifically address the use of contractors, at least two contractors were part of the CFO team. These were Tecolote and Coopers and Lybrand, of which the latter has experience working with an Army CFO project. In addition to these contractors, DFAS-CL also has used the expertise of Diverse Technology Corporation (DTC). Tecolote and Coopers and Lybrand also accompanied DFAS, Navy, and Naval Audit Service personnel in visits to DFAS-Indianapolis (Army) and DFAS-Denver (Air Force) Centers in gathering lessons learned knowledge.

Now on pp. 4, 22-24.

FINDING F: Improving Financial Systems. The GAO noted that the CFO Project Plan does not provide short-term strategies for improving existing financial systems operations. Overall, the GAO reported the systems deficiencies substantially increase the difficulty and time required to develop the Navy financial reports. The GAO further reported that such deficiencies significantly increase the risk of errors, and, without compensating controls, increase the Navy and the DoD exposure to undetected fraud, waste, and mismanagement. According to the GAO, DoD and Navy officials have acknowledged that systems deficiencies severely hamper their ability to effectively carry out accounting and financial reporting for the Navy. (p. 5, pp. 36-39/GAO Draft Report)

Discussed on p. 24.

DOD RESPONSE: Partially concur. The CFO Project Plan contains sections that identify systems currently used for General Fund reporting, assesses their ability to support CFO reporting and determines corrective actions necessary for FY 1996 reporting. The Standard Accounting and Reporting System (STARS) has been designated as the vehicle for General Fund departmental reporting, including CFO reporting. The CFO Project Plan will be updated to designate STARS-Departmental Reporting (DR) [STAR-DR] as the target CFO generation system. DFAS-CL recently designated the Naval Headquarters Financial System (NHFS) as a back-up system to the STARS-DR system. The NHFS, while not optimal, will better assure the ability of the DFAS-CL to produce CFO statements for FY 1996. It should be noted that the entire CFO Project Plan is short term (less than a year) in nature. The ultimate solution is

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standardized systems and data. It is unrealistic to expect the plan to correct all systems and processes within a time span of less than a year. Additionally, as previously noted, both the DFAS and the Department of the Navy (DON) have made notable progress in preparing CFO submissions for the DBOF activities and the DON Trust Funds. Continued work currently is in process to prepare for the FY 1996 CFO general funds submission. Progress is being made, but it will take time to implement the new financial management structures necessary to produce quality financial statements.

FINDING G: Recently Issued DoD Policy Intended To Clarify Accountability For Financial Management And Reporting. The GAO determined that, in the past, the DoD has not clearly defined or strictly enforced accountability between the Navy and the DFAS for the Navy financial management and reporting operations and for meeting the CFO Act requirements. The GAO noted that, on November 15, 1995, the DoD Comptroller's Office issued a Department-wide policy, "Roles and Responsibilities of the DoD Component and the Defense Finance and Accounting Service Relative to Finance and Accounting Operations and Departmental Reports." The GAO noted that the policy generally does not impose new requirements, as many of the provisions were already required by the DoD regulations prior to the Comptroller's issuance of the guidance. The GAO further reported that neither the DFAS nor the Military Services consistently have followed required procedures. The GAO found no evidence that failure to follow established procedures resulted in disciplinary or other adverse actions except in instances also involving violations of laws. (p. 5, pp. 39-41/GAO Draft Report)

Now on pp. 4, 24-26.

Discussed on p. 25.

DOD RESPONSE: Partially concur. The roles and responsibilities of the DoD Components and the Defense Finance and Accounting Service relative to finance and accounting operations and Departmental reports was approved by the Under Secretary of Defense (Comptroller) on November 15, 1995, and also will be published in the DoD Financial Management Regulation. The DoD is concerned, however, that the finding tends to underplay the importance of the document by stating that it "generally does not impose new requirements, as many of the provisions are already required by the DoD regulations." It is important to keep in mind that the Defense Finance and Accounting Service has only been in existence since January 1991. Previously, each Military Service and many Defense Agencies performed its own accounting and finance functions. While specific requirements were, and continue to be, contained in various issuances, whether the DFAS or the other DoD Components were responsible for accomplishing these requirements was not always clearly stated. Further, due to accounting and finance consolidations, the roles and responsibilities of the Defense Finance and Accounting Service relative to its customers were not formalized and therefore not clear to all parties. The roles and responsibilities guidance approved by the Under Secretary of Defense (Comptroller) on November 15, 1995, should have a significant influence on focusing attention by the various parties on areas for which they are responsible.

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RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the DoD Comptroller and the Navy's Assistant Secretary for Financial Management and Comptroller,

- jointly act to improve the credibility of the Navy's financial reports and to adequately position the Navy and the DFAS to prepare auditable financial statements for the Navy, beginning with those for FY 1996, and)
- periodically report to the Secretary of Defense the status of their results.

DOD RESPONSE: Concur. The Under Secretary of Defense (Comptroller) and the Assistant Secretary of the Navy (Financial Management and Comptroller) have worked, and will continue to work together jointly. As previously stated, the DoD, the DFAS, and the Navy continue to assign a high priority and instill a sense of urgency for meeting the objectives of the CFO Act. The Department of the Navy and the DFAS jointly are working to implement in FY 1996 CFO financial statement reporting requirements for the general funds, the DBOF and the Trust Funds within the Department of the Navy.

RECOMMENDATION 2: The GAO recommends that, to avoid the mistakes made in preparing the Navy FY 1994 consolidated financial reports, the Navy and the DFAS should diligently attain the greatest degree of accuracy possible in finalizing the Navy FY 1995 consolidated financial reports. This is especially critical because data in these reports will help establish the opening balance for FY 1996. These actions would, at minimum, require that:

- financial reports be compiled in accordance with Treasury and the DoD requirements;
- financial information be reviewed thoroughly to determine its reasonableness, accuracy, and completeness;
- adjustments to account balances and reports be fully documented as to their basis and purpose; and
- the Assistant Secretary of the Navy for Financial Management and Comptroller certify that financial reports comply with applicable requirements. (pp. 44-45/GAO Draft Report):

DOD RESPONSE: Partially concur. Actions recommended by the GAO in this recommendation are addressed individually below.

- 2.a. The GAO recommends that the Navy and the DFAS compile financial reports in accordance with Treasury and the DoD requirements.

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See comment 3.

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DOD RESPONSE: Concur. However, it should be noted that the Treasury no longer requires submission of financial reports in the SF 220 series format. Currently, the DoD annually issues DoD Guidance on Form and Content of Financial Statements based on guidance received from the Office of Management and Budget (OMB) in the form of OMB Bulletins.

2.b. The GAO recommends that the Navy and the DFAS review financial information thoroughly to determine its reasonableness, accuracy, and completeness.

DOD RESPONSE: Concur. In accordance with the roles and responsibilities guidance approved by the Under Secretary of Defense (Comptroller) on November 15, 1995, a review of reported financial information is required. As evidence of that review, both the reporting entity and the DFAS are now required to verify the accuracy and completeness of the report.

2.c. The GAO recommends that the Navy and the DFAS document adjustments to account balances and reports as to their basis and purpose.

DOD RESPONSE: Concur. In accordance with the roles and responsibilities guidance approved by the Under Secretary of Defense (Comptroller) on November 15, 1995, adjustments to account balances and reports are required to be fully documented.

2.d. The GAO recommends that the Assistant Secretary of the Navy for Financial Management and Comptroller certify that financial reports comply with applicable requirements.

DOD RESPONSE: Partially concur. The annual Navy financial statements prepared under the requirements of the Chief Financial Officers Act of 1990 are required to be accompanied by a management representation letter signed by the Secretary or Under Secretary of the Navy. The Department believes that the management representation letter is the appropriate medium in which to provide management comments. Additionally, in accordance with the roles and responsibilities guidance approved by the Under Secretary of Defense (Comptroller) on November 15, 1995, the reporting entity is responsible for annual certifications required by 31 U.S.C. 1501(b). However, there is no requirement to certify the SF 220 reports.

RECOMMENDATION 3: The GAO recommends, so that FY 1996 and subsequent financial statements for Navy operations are auditable, the Navy and the DFAS should place high priority on implementing basic required financial controls over Navy financial accounts and reports. The minimum requirements to carry out this step would include assurance that:

- Navy's periodic physical inventories of equipment, property, and inventories are taken, the results are reported to the DFAS, and any discrepancies are investigated as to cause and resolved;
- reconciliations of accounts and records are made, significant discrepancies are examined and resolved, and appropriate adjustments are made;

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- transactions are clearly and completely documented and such documentation is retained and readily available to support account balances;
- account balances are analyzed and financial reports are reviewed to detect abnormal account balances and unusual fluctuations and trends, any significant variances are researched and are explainable and any necessary corrections are made; and
- basic internal control requirements are enforced and the Navy and the DFAS should develop and implement strategies for monitoring progress throughout the year. (pp. 45-46/GAO Draft Report).

DOD RESPONSE: Concur. Actions recommended by the GAO in this recommendation are addressed individually below.

3.a. The GAO recommends that the Navy take periodic physical inventories of equipment, property, and inventories, report the results to the DFAS, and investigate and resolve any discrepancies as to cause.

DOD RESPONSE: Concur. In accordance with the roles and responsibilities guidance approved by the Under Secretary of Defense (Comptroller) on November 15, 1995, the supporting records for many financial balances are maintained by the DFAS customers and are outside the control of the DFAS. When subsidiary records are maintained by the DoD Component customer, outside the control of the DFAS for, as an example, assets such as inventories, plant property, and equipment, the customer shall validate periodically the accuracy of such subsidiary records on a sample or other authorized basis against applicable physical assets or other appropriate confirmations of the source documents.

3.b. The GAO recommends that the Navy and the DFAS reconcile accounts and records, examine and resolve significant discrepancies, and make appropriate adjustments.

DOD RESPONSE: Concur. In accordance with the roles and responsibilities guidance for the DoD Components and the DFAS, the Navy and the DFAS are responsible for different aspects of reconciliations and resolution of discrepancies. The roles and responsibilities document specifies the responsibilities of the DFAS and its customers. Additionally, the September 1, 1995, Director, DFAS, memorandum on the preparation of CFO Act FY 1995 financial statements stresses DFAS's responsibility for performing reconciliations of account balances.

3.c. The GAO recommends that the Navy and the DFAS clearly and completely document transactions and retain and keep readily available such documentation to support account balances.

DOD RESPONSE: Concur. In accordance with the November 15, 1995, roles and responsibilities guidance for the DoD Components and the DFAS, the Navy is responsible for ensuring that audit trails are maintained in sufficient detail to permit tracing of transactions from its source to its transmission to the DFAS. The DFAS is responsible for ensuring that a

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complete and documented audit trail is maintained to support the reports it prepares. This responsibility is also stressed in the September 1, 1995, Director, DFAS, memorandum on preparation of CFO Act FY 1995 financial statements.

3.d. The GAO recommends that the Navy and the DFAS analyze account balances and review financial reports to detect abnormal account balances and unusual fluctuations and trends, research any significant variances to determine if they are explainable and make any necessary corrections.

DOD RESPONSE: Concur. In accordance with the November 15, 1995, roles and responsibilities guidance for the DoD Components and the DFAS, the Navy is responsible for researching any unusual trends and making comparisons with prior year and/or prior period amounts to determine what corrective actions are appropriate or needed. The DFAS is responsible for identifying and calling to the attention of the customer for appropriate action or analysis unusual trends and comparisons with prior year and/or prior period amounts. Additionally, system enhancements to the STARS-DR will provide a mechanical capability to identify abnormal balances within and between reports and perform trend analysis.

3.e. The GAO recommends that the Navy and the DFAS enforce basic internal control requirements and the Navy and the DFAS develop and implement strategies for monitoring progress throughout the year.

DOD RESPONSE: Concur. The September 1, 1995, DFAS memorandum on the preparation of CFO Act financial statements directs that DFAS management update its internal control/quality assurance checklists and prepare a plan of action and milestones to manage the CFO reporting process.

RECOMMENDATION 4: The GAO recommends that the Navy and the DFAS should immediately prepare implementing strategies for producing reliable financial statements for the Navy, beginning with those for FY 1996. This plan should, at a minimum:

- address staffing issues, such as filling financial management vacancies, upgrading the experience of financial managers, and using contractors, as necessary, to improve financial management operations;
- include short-term measures to improve the data in existing financial systems, follow existing systems operating and transaction processing requirements, and use standard data elements, such as object class codes;
- incorporate strategies for promptly meeting DoD's requirement to use the U.S. Standard General Ledger and Treasury's Federal Agencies Centralized Trial Balance System; and
- identify the individuals accountable for accomplishing the actions established by the strategies and provide a means for monitoring implementation throughout the year. (pp. 46-47/GAO Draft Report)

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DOD RESPONSE: Partially concur. Actions recommended by the GAO in this recommendation are addressed individually below.

4.a. The GAO recommends that the Navy and the DFAS address staffing issues, such as filling financial management vacancies, upgrading the experience of financial managers, and using contractors, as necessary, to improve financial management operations.

DOD RESPONSE: Concur. Although additional personnel are desirable, the Department of the Navy is under severe personnel constraints and does not have the funding to hire the many additional personnel necessary to accomplish, manually, the multitude of additional actions recommended by the GAO. The DFAS has taken steps to assess DFAS-CL personnel needs. DFAS-CL recently received resource authorizations from DFAS-HQ to meet their CFO personnel needs. Fourteen new accountants and financial analysts have recently started work in the authorized positions and recruitment continues. DFAS-CL is bringing new staff on as they become available and at least six new accountants are expected to join the DFAS-CL CFO team in early February 1996 and an additional seven expected by the end of February.

4.b. The GAO recommends that the Navy and the DFAS include short-term measures to improve the data in existing financial systems, follow existing systems operating and transaction processing requirements, and use standard data elements, such as object class codes.

DOD RESPONSE: Concur. The CFO Project Plan contains sections that identify systems currently used for General Fund reporting, assesses their ability to support CFO reporting and determines corrective actions necessary for FY 1996 reporting. The Standard Accounting and Reporting System (STARS) has been designated as the vehicle for General Fund departmental reporting, including CFO reporting. The CFO Project Plan will be updated to designate STARS-DR as the target CFO generation system. The DFAS-CL recently designated the NHFS as a back-up system to the STARS-DR system. The NHFS, while not optimal, will assure the ability of DFAS-CL to produce CFO statements for FY 1996.

4.c. The GAO recommends that the Navy and the DFAS incorporate strategies for promptly meeting DoD's requirement to use the U.S. Standard General Ledger and Treasury's Federal Agencies Centralized Trial Balance System (FACTS).

DOD RESPONSE: Concur. The CFO Project Plan addresses the issues of the U.S. Standard General Ledger and FACTS. Task 10 of the CFO plan specifically states that the team will coordinate its effort with the FACTS effort. The DFAS requires the development of separate plans of action and milestones for CFO reporting, FACTS, and interim migratory systems projects; and maintains periodic updates. As an example, in November 1995, representatives of the Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) and the DFAS-Cleveland Center provided updates to the CFO Project Plan to include the latest management and procedures changes (i.e., FACTS reporting).

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4.d. The GAO recommends that the Navy and the DFAS identify the specific offices or positions accountable for accomplishing the actions established by the strategies and provide a means for monitoring implementation throughout the year.

DOD RESPONSE: Partially concur. The overall execution of the CFO Project Plan is the responsibility of the OASN(FM&C) and the DFAS. The CFO Project Plan will be revised to indicate participating organizations and responsible elements within those organizations.

RECOMMENDATION 5: The GAO recommends that--given the history of problems in preparing the Navy financial reports--the DoD Comptroller's November 15, 1995, policy on roles and responsibilities of the DoD Components and DFAS be supplemented with strategies to hold organizations and individuals accountable for effectively carrying them out, milestones for monitoring implementation progress during the year, and periodic assessments during annual financial reporting cycles to ensure that the roles and responsibilities are continually enforced. (p. 47/GAO Draft Report)

DOD RESPONSE: Concur. As noted previously, the DFAS has developed, in conjunction with the OASN(FM&C), a CFO Project Plan that is updated monthly and that will be revised to indicate participating organizations and elements within those organizations responsible for carrying out indicated actions. In November 1995, representatives of the OASN(FM &C) and the DFAS-Cleveland Center met to establish an executive steering committee and to designate a functional implementation steering committee consisting of Navy and DFAS personnel. These committees should serve to assure that the objectives of the CFO Project Plan are met.

Enclosure
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Discussed on pp. 30-31.

Now on p. 29.

The following are GAO's comments on the Department of Defense letter dated February 9, 1996.

GAO Comments

1. We have changed the title of this report to CFO Act Financial Audits: Increased Attention Must Be Given to Preparing Navy's Financial Reports.
2. The "improvements and progress" listed by DOD represent actions from which envisioned benefits have yet to be achieved. While these actions may lead to improvements in the Navy's financial management operations, in our view they do not materially affect our finding.
3. OMB, under authority established by the CFO Act, prescribes the form and content of agency financial statements prepared pursuant to that act and GMRA. Therefore, we have modified our recommendation to incorporate the OMB requirements.

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