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Report to the Chairman, Committee on the Budget, House of Representatives

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CFO ACT FINANCIAL AUDITS

Programmatic and Budgetary Implications of Navy Financial Data Deficiencies

GAO/AIMD-98-56

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General Accounting Office
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Accounting and Information Management Division

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March 16, 1998

The Honorable John R. Kasich
Chairman, Committee on the Budget
House of Representatives

Dear Mr. Chairman:

One basic objective of the Chief Financial Officers (CFO) Act is to improve the financial information available to agency managers and to the Congress. The act called for the integration of the federal government's accounting and budgeting systems and the preparation and independent audit of financial statements. This link between accounting and budgeting systems and the rigors of a financial audit is intended to improve the accuracy of data used in budgeting and help ensure that oversight officials have accurate and complete information to assess whether agencies are spending their funds as intended by the Congress.

This report responds to your request that we analyze the programmatic and budgetary implications of the financial data deficiencies enumerated by the auditors' examination of the Department of the Navy's fiscal year 1996 financial statements.[1] In its first attempt to audit the Navy's financial statements, the Naval Audit Service reported in March 1997 that it was unable to render an opinion on the fiscal year 1996 financial statements. This means that, despite extensive audit efforts, the Navy's financial records were in such poor condition that the auditors could not tell whether or not the statements were accurate. The Naval Audit Service concluded that the Navy did not have reliable information on "the value of assets and liabilities, including the status of funds appropriated." In essence, the Navy did not have adequate records to document what it had, what it owed, or how much money it had spent. This is of particular concern since the Navy is responsible for about one-third of the Department of Defense's (DOD) gross budget authority, controls an estimated one-half of the reported value of DOD assets, and employs about 1 million military and civilian personnel.

It is vitally important that the Navy obtain accurate financial information if it is to effectively manage the vast resources for which it is accountable.

[1]Your request also asked that we analyze the financial reporting and associated auditors' reports detailing the implications of financial deficiencies at the Forest Service and the Federal Aviation Administration. As agreed with your office, we have reported to you separately on these agencies. (See Financial Management: Federal Aviation Administration Lacked Accountability for Major Assets (GAO/AIMD-98-62, February 18, 1998) and Forest Service: Status of Progress Toward Financial Accountability (GAO/AIMD-98-84, February 27, 1998).)

Credible financial data are critical not only for preparing auditable financial statements but also to provide a reliable basis for Navy and DOD managers and congressional officials to make difficult resource allocation and program management decisions.

Results in Brief

The extent and nature of the Navy's financial deficiencies identified by the auditors, including those that relate to supporting management systems, increase the risk of waste, fraud, and misappropriation of Navy funds and can drain resources needed for defense mission priorities. Critical weaknesses identified by the auditors and their implications include the following.

- Information on $7.8 billion in inventories on board ships was not included in Navy's year-end financial statements. This information was omitted from the inventory data used for inventory management, budgeting, and financial reporting. The lack of Navy-wide visibility over inventories substantially increases the risk that the Navy may request funds to obtain additional inventories that are not needed because responsible managers may not receive information that some of these inventories may already be on hand in excess.
- Failure to follow prescribed procedures for controlling Navy's cash account with Treasury contributes to continuing disbursement accounting problems that not only prevent reliable financial statement reporting, but increase the risk of overspending or overobligating Navy's appropriations. For example, the auditors reported that the lack of controls over the Navy's Fund Balance With Treasury may result in Antideficiency Act violations.
- Until duplicate and erroneous vendor payments were identified and collected as a result of the financial audit, the Navy not only paid too much for goods and services but, more importantly, was unable to use these funds to meet other critical programmatic needs. We recently reported[2] that for fiscal years 1994 through 1996, contractors returned to DOD checks totaling about $1 billion per year that related to payments from the Navy, the other military services, and other DOD agencies.
- Breakdowns in the controls relied on to prevent or detect material financial errors mean that the Navy cannot tell if its business-type support operations are operating on a break-even basis as intended. For example, the auditors reported that inventory records differed from quantities actually in storage about 22 percent of the time. Inaccurate records could

[2]DOD Procurement: Funds Returned by Defense Contractors (GAO/NSIAD-98-46R, October 28, 1997).

result in decisions to buy the wrong quantity of an item, which could result in either excess inventory or shortages.

Although the Navy's 1996 financial statements—its first effort to prepare comprehensive financial statements[3]—did not include all required information and were not verifiable, they still provided data that could be used to identify several financial issues that may be of interest to budget and program managers. For example, footnote disclosures on the Navy's accounts receivable and unexpended appropriations raise questions about whether future budget resources may be needed or whether there may be opportunities to reduce resource requirements. To illustrate, if accounts receivable are overstated, the Navy may not receive amounts that it intended to use to support its operations and may therefore need to obtain additional funding. If the amount is understated, the Navy may lack the visibility necessary to ensure that it is taking appropriate action to collect all amounts due it. When the findings presented in the auditors' reports are corrected, the financial statements themselves and related notes can become an excellent source of information on the financial condition and operations of the Navy.

Also, if properly implemented, new accounting standards that require information such as data on asset disposal costs and deferred maintenance will provide the Navy and the Defense Finance and Accounting Service (DFAS)[4] with an opportunity to improve the extent and usefulness of information that is currently available to support program decision-making and accountability in these areas.

Background

The CFO Act of 1990 requires DOD and other agencies covered by the act to improve their financial management and reporting operations. One of 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 required to comply with applicable principles and standards and provide for complete, reliable, consistent, and timely information needed to manage agency operations. Beginning with fiscal year 1991, the CFO Act required agencies, including

[3]The Navy, like all other federal entities, has been required to prepare and submit a prescribed set of financial information to the Treasury since 1950. However, fiscal year 1996 was the first year the Navy's required financial reporting for its activities financed using general funds included the more detailed descriptive information called for under the CFO Act, as amended.

[4]DFAS, which provides accounting services for the military services, was established in January 1991 to improve, standardize, and consolidate DOD's finance and accounting policy, systems, and operations.

the Navy, to prepare financial statements for their trust and revolving funds, and for their commercial activities. The CFO Act also established a pilot program under which the Army and Air Force, along with eight other federal agencies or components, were to test whether agencywide audited financial statements would yield additional benefits.

The Congress concluded that agencywide financial statements contribute to cost-effective improvements in government operations. Accordingly, the Government Management Reform Act of 1994 made the CFO Act's requirements for annual audited financial statements permanent and expanded it to include virtually the entire executive branch. Under this legislative mandate, DOD is to annually prepare and have audited DOD-wide and component financial statements beginning with fiscal year 1996. The Office of Management and Budget (OMB) has designated Navy and the other military services as "components" that will be required to prepare financial statements and have them audited. Because the Navy was not one of the pilot agencies, fiscal year 1996 was the first year for which it was required to prepare agencywide financial statements for its general funds.

In October 1990, the Federal Accounting Standards Advisory Board (FASAB) was established by the Secretary of the Treasury, the Director of OMB, and the Comptroller General to consider and recommend accounting standards to address the financial and budgetary information needs of the Congress, executive agencies, and other users of federal financial information. Using a due process and consensus-building approach, the nine-member Board, which, since its formation has included a member from DOD, recommends accounting standards for the federal government. Once FASAB recommends accounting standards, the Secretary of the Treasury, the Director of OMB, and the Comptroller General decide whether to adopt the recommended standards. If they are adopted, the standards are published as Statements of Federal Financial Accounting Standards (SFFAS) by OMB and by GAO. In addition, the Federal Financial Management Improvement Act of 1996, as well as the Federal Managers' Financial Integrity Act, requires federal agencies to implement and maintain financial management systems that will permit the preparation of financial statements that substantially comply with applicable federal accounting standards.

Navy Financial Statement Preparation and Audit Responsibilities

For fiscal year 1996, the Navy prepared two separate sets of statements: one for its operations financed with general funds and another for operations financed using funds provided through the Defense Business Operations Fund (DBOF).[5] The Defense Finance and Accounting Service-Cleveland Center supported the Navy in preparing the fiscal year 1996 financial statements for activities financed by general funds and DBOF.

The Navy's general fund financial statements encompassed those operations financed through 24 general fund accounts.[6] These general funds included moneys the Congress appropriated to the Navy to pay for related authorized transactions for periods of 1 year, multi-years, or on a "no-year" basis.[7] The Navy's DBOF business activities are financed primarily through transfers from the Navy's Operations and Maintenance appropriations, based on the costs of goods and services to be provided. The Navy has historically operated many supply and industrial facilities using a working capital fund concept. In fiscal year 1996, the Navy's business activities comprised the largest segment of DOD's support operations financed through DBOF.

The DOD Inspector General delegated responsibility for auditing Navy's fiscal year 1996 financial statements to the Naval Audit Service. By agreement with the DOD Inspector General, the Naval Audit Service's fiscal year 1996 audit encompassed two separate efforts, both limited to the Navy's Statement of Financial Position and related footnotes.[8] The audit resulted in one set of reports focused on the Navy's financial statement reporting for its operations financed using general funds and one overall report summarizing the results of its review of the Navy's DBOF-financed

[5]The Navy was responsible for directly managing the goods and services provided through the Navy's business areas, although they were financed through DBOF. Consistent with this management practice, on December 11, 1996, the Under Secretary of Defense (Comptroller) reorganized DBOF and created four working capital funds: Army, Navy, Air Force, and Defense-wide.

[6]General Fund accounts are composed of federal money not allocated to any other fund account.

[7]"No-year" appropriations remain available for obligation for their original purposes until expended.

[8]The Statement of Financial Position is intended to show the value of the Navy's assets and liabilities. The Navy's other fiscal year 1996 financial statements, which were not audited by the Naval Audit Service, were the Statement of Operations and Changes in Net Position and the Statement of Cash Flows.

operations.[9] The set of general fund reports included an overall auditor's opinion report, an overall report on internal controls and compliance with laws and regulations, and eight other more detailed supporting reports.

Appendix I shows the status of Navy entities' financial statement audits in fiscal year 1996. Appendix II provides a complete listing of the Naval Audit Service reports issued as a result of its fiscal year 1996 financial statement audit efforts.

Objectives, Scope, and Methodology

The objectives of this report were to (1) analyze the extent to which financial deficiencies detailed in the auditors' reports may adversely impact the ability of Navy and DOD managers and congressional officials to make informed programmatic and budgetary decisions, (2) provide examples of other issues of interest to budget and program decisionmakers that can be identified by reviewing the financial statements, and (3) describe the additional financial data that, if complete and accurate, could be used to support future decision-making when the Navy implements accounting standards that are effective beginning with fiscal years 1997 and 1998.

To accomplish these objectives, we obtained and analyzed the Naval Audit Service's opinion report and other supporting reports resulting from its examination of the Navy's fiscal year 1996 financial statements to identify data deficiencies and determine their actual or potential impact on Navy programmatic or budgetary decision-making. To do this, we compared the Naval Audit Service's audit results with the findings and related open recommendations in our previous reports that discuss the implications of Navy's financial deficiencies. We also obtained additional details on the Naval Audit Service's findings through discussions with cognizant Naval Audit personnel, and we discussed the status of our previous findings and recommendations with cognizant Navy and DFAS personnel. Further, we independently reviewed Navy's financial statements to identify other issues of interest to budget and program decisionmakers, particularly those areas that may indicate the need for future budget resources or that may provide the opportunity to reduce resource requirements. Finally, we analyzed recently adopted federal accounting standards to identify areas

[9]The Naval Audit Service was not responsible for offering a separate opinion on the Navy's DBOF operations. Instead, the results of the Naval Audit Service's review of Navy's DBOF operations were provided to the Department of Defense Inspector General for inclusion in its auditors' report on DOD for the Defense Business Operations Fund Consolidating Financial Statements. That report disclaimed an opinion because of significant accounting system deficiencies and unsound control procedures. The auditors concluded that DOD's financial statements for its DBOF-funded operations could not be relied on for making decisions or assessing performance.

where Navy program and budget managers will have additional useful information available to support decision-making, if the standards are effectively implemented as required.

Our work was conducted from December 1997 through February 1998 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of Defense or his designee. On March 9, 1998, the Principal Deputy Under Secretary of Defense (Comptroller) provided us with written comments, which are discussed in the "Agency Comments and Our Evaluation" section and are reprinted in appendix III.

Implications of Pervasive Financial Problems Identified by Auditors

To an even greater extent than the other military services, the Navy has been plagued for years by troublesome financial management problems involving billions of dollars. For example, our 1989 report[10] on the results of our examination of Navy's fiscal year 1986 financial reporting detailed numerous problems, such as understating the value of Navy's assets by $58 billion, that we attributed to carelessness and the failure to perform required rudimentary supervisory reviews and reconciliations.

Seven years later, we found that such problems persisted. In our report[11] on the Navy's fiscal year 1994 financial reporting, we reported that the Navy had not taken advantage of the 5 years that had passed since the enactment of the CFO Act or the experiences of its counterparts, the Army and the Air Force, in preparing financial statements. Our report identified a minimum of $225 billion of errors in the $506 billion in assets, $7 billion in liabilities, and $87 billion in operating expenses reported to the Department of the Treasury in the Navy's fiscal year 1994 consolidated financial reports. Consequently, we concluded that the Navy and DFAS had to play "catch up" if they were to successfully prepare reliable financial statements on the Navy's operations.

Most recently, the Naval Audit Service's April 1997 report on the results of its audit of the Navy's fiscal year 1996 financial reporting disclosed that errors, misstatements, and internal control weaknesses continued. A number of the financial data and control deficiencies disclosed in the Naval Audit Service's reports not only adversely affect the reliability and

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

[11]CFO Act Financial Audits: Increased Attention Must Be Given to Preparing Navy's Financial Reports (GAO/AIMD-96-7, March 27, 1996).

usefulness of the Navy's financial reporting but also have significant programmatic or budgetary implications. Our analysis of the auditors' reports, along with additional examples from our own audit work, is provided in the following sections.

Budget Development Is Undermined by Lack of Accurate Inventory Data

The Naval Audit Service report on the results of its financial audit of the Navy's fiscal year 1996 financial statements disclosed numerous problems with inventory data reported by the Navy, including the following.

"The Department of the Navy did not report an estimated $7.8 billion in Operating Materials and Supplies items aboard ships or with Marine Corps activities on the FY 1996 Statement of Financial Position."

We previously reported that DOD has spent billions of dollars on inventory that is not needed to support war reserve or current operating requirements and burdened itself with managing and storing the unneeded inventory.[12] The financial reporting error disclosed by the Naval Audit Service has implications for the budget process because the inventory data used both for the financial statements and as the starting point for the Navy's process to develop budget requests for additional inventory are incomplete. A Stratification Report is used to prepare data on the quantity and value of the Navy's inventories, such as operating materials and supplies, included in the Navy's financial statements. It is also used as the starting point to forecast budget requirements for inventories that will be needed in supply warehouses. To determine Navy-wide inventory requirements, responsible managers must also have accurate, reliable information on the quantities of inventories on ships, including any quantities in excess of needs.

However, the auditors found that information on $7.8 billion in inventories, including those on board ships was not included in the Navy's year-end financial statements. This lack of Navy-wide visibility over inventories substantially increased the risk that Navy may have requested funds to obtain additional unnecessary inventories because responsible managers did not receive information that excess inventories were already on hand in other locations. This happened in the past, as discussed in our report[13] on financial audit work we performed to help the Navy prepare for the fiscal year 1996 audit. We found that for fiscal year 1994, the Navy's

[12]High-Risk Series: Defense Inventory Management (GAO/HR-97-5, February 1997).

[13]Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings (GAO/AIMD-96-94, August 16, 1996).

inventory item managers did not have adequate visibility over $5.7 billion in operating materials and supplies on board ships and at 17 redistribution sites. Approximately $883 million of these inventories were excess to current operating allowances or needs. For the first half of fiscal year 1995, inventory item managers had ordered or purchased items for some locations that had been identified as excess at other locations and thus were already available. As a result, we identified unnecessary spending of at least $27 million. Further, a review of inventory item managers' forecasted spending plans for the second half of fiscal year 1995 and fiscal years 1996 and 1997 found planned purchases of items already available in excess at other locations could result in the Navy incurring approximately $38 million of unnecessary costs.

Our recent discussions with Navy officials confirmed that as of December 1997, the process used to accumulate inventory status information still did not provide inventory managers complete information on operating material and supplies inventories, particularly information on the quantities of Navy operating and supply inventories on ships. As a result, the Navy's budget requests for inventory may continue to not accurately reflect its needs.

Navy Could Not Account for Its Cash Balance With Treasury

The Naval Audit Service's fiscal year 1996 audit report stated the following.

> "The Department of the Navy could not effectively account for the balance in the Fund Balance with Treasury because Defense Finance and Accounting Service - Cleveland Center had not developed an adequate accounting system to do so. Consequently, the Department of the Navy cannot provide reasonable assurance that: (1) the $64.8 billion account balance reported on the FY 1996 Statement of Financial Position presents fairly its financial position, or (2) transactions that could cause Antideficiency Act violations would be detected as required by Department of Defense guidance. Defense Finance and Accounting Service principally used Department of the Treasury data in reporting the Fund Balance with Treasury because the data was considered more reliable than the data provided by the Navy's accounting systems. Department of Defense guidance requires that the Fund Balance with Treasury be supported by records of the entity."

This situation is similar to an individual not being able to reconcile his or her checkbook register to the monthly statement received from the bank. Just as with an individual's checkbook, reconciliations are necessary to ensure that any differences are identified, the cause researched, and appropriate corrective action taken. Such reconciliations allow the individual to identify not only clerical errors but potential fraudulent misuse of his or her account. For example, blank checks can be stolen and forged and the amounts on otherwise legitimate checks can be altered. The potential consequences of the lack of regular reconciliations is increased dramatically for the Navy given that the agency reported $63 billion in fiscal year 1996 general fund expenditures and also has had continuing problems in properly recording billions of dollars of transactions.

The lack of complete records for all disbursements and regular reconciliations can also result in the Navy spending more funds than it has available. Federal agencies are required to record obligations as legal liabilities are incurred and make payments from the associated appropriations within the limitations established by the Congress. To the extent that the Navy does not properly record all its disbursements, its ability to ensure that it will have enough funding available to pay for its expenses will continue to be adversely affected. This is similar to an individual not properly maintaining his or her checkbook register by neglecting to record checks written and, at the end of the month, finding that the account is now overdrawn.

As noted by the auditors, the lack of controls over the Fund Balance with Treasury may result in Antideficiency Act violations.[14] In addition, in our March 1996 report,[15] we disclosed that problems in keeping records on Navy's disbursements resulted in understating by at least $4 billion the federal government's overall budget deficit reported as of June 30, 1995. In the current environment, such errors could make the difference between the federal government reporting a budget deficit or surplus.

Erroneous and Duplicate Payments Identified by Auditors Affect Amount of Funds Available

The extensive problems identified in the Navy's disbursement process also resulted in erroneous and duplicate payments to vendors, as stated in the auditors' report.

"Defense Finance and Accounting Service Operating Locations processed 110 duplicate or erroneous vendor payments for the Department of the Navy. Of these, 62, valued at $2.5 million, had not been previously identified for collection....The improper payments were the result of input errors, failure to conduct reviews, ambiguous reports, and

[14]Under the Antideficiency Act, federal agency officials may not "make or authorize an expenditure or obligation exceeding an amount available in an appropriation or fund" (31 U.S.C. 1341).

[15]CFO Act Financial Audits: Increased Attention Must Be Given to Preparing Navy's Financial Reports (GAO/AIMD-96-7, March 27, 1996).

improper processing of invoices....The $2.5 million in duplicate or erroneous payments we identified and the Operating Locations collected represent funds that can be put to better use."

The auditors' findings were based on a limited judgmental sample of about 400 payments out of a universe of about 1.2 million payments Navy made during fiscal year 1996. DOD officials informed us that subsequent investigation showed that not all of the $2.5 million were actually duplicate or erroneous payments that could be put to better use. However, the Naval Audit Service has not yet validated these results.

Nonetheless, the control weaknesses identified, along with our previous work on DOD's long-standing problems with overpayments to contractors and vendors, suggest that significant additional, undetected erroneous payments likely exist. Most recently, we reported[16] that for fiscal years 1994 through 1996, contractors returned checks to DFAS totaling about $1 billion a year. These related to payments from the Navy, the other military services, and other Defense agencies. For the first 7 months of fiscal year 1997, DFAS's Columbus Center received checks returned by contractors totaling about $559 million. DOD's reliance on contractors to identify these overpayments substantially increases the risk that it is incurring unnecessary and erroneous costs. Because of our continuing concerns with control breakdowns in the contract payment area across the department, we have continued to monitor this area as one of the high-risk federal areas most vulnerable to waste, fraud, abuse, and mismanagement.[17]

Lack of Reliable Financial Information Impairs Management of Navy's Businesslike Operations

By establishing DBOF in 1991, the Department of Defense intended to focus management attention on the total costs of its businesslike support organizations to help manage these costs more effectively. DBOF was modeled after businesslike operations in that it was to maintain a buyer-seller relationship with its military customers, primarily the Navy and the other military services. DBOF-funded operations were to operate on a break-even basis by recovering the current costs incurred in conducting its operations, primarily from operations and maintenance funding provided by its customers.

The Naval Audit Service reported a number of serious financial deficiencies in its fiscal year 1996 review of Navy's DBOF activities.

[16]DOD Procurement: Funds Returned by Defense Contractors (GAO/NSIAD-98-46R, October 28, 1997).

[17]High-Risk Series: Defense Contract Management (GAO/HR-97-4, February 1997).

"[I]nternal controls were not adequate to detect or prevent errors. For example, inventory records were inaccurate; fixed assets were not capitalized or depreciated properly; depreciation on fixed assets at closing activities was not included on financial statements; payables were not always processed accurately or timely; accruals were inaccurate because of lack of reconciliations; liabilities were inaccurate because of untimely processing and bookkeeping errors; and Military Sealift Command financial accounting information was inaccurate due to inadequate general ledger and subsidiary ledger controls and accounting records."

The following examples of data deficiencies, when considered along with the Naval Audit Service's overall assessment of material weaknesses in the Navy's DBOF operations, have an adverse effect on the Navy's ability to reliably determine DBOF's net operating results. These financial deficiencies adversely affect not only the Navy's DBOF financial reporting but also its ability to achieve the goal of operating on a break-even basis. Reliable information on the DBOF's net operating results is a key factor in setting the prices DBOF charges its customers. As a result of the problems pointed out by the Naval auditors, neither DOD nor congressional officials can be certain (1) of actual DBOF operating results and (2) if the prices DBOF charges its customers are reasonable for the goods and services provided.

Our recent reporting demonstrates the Navy's continuing problems in achieving the goal of operating its businesslike activities on a break-even basis. For example, in March 1997, we reported[18] that DBOF management's inability to stem continuing losses occurred as a result of, among other factors, inaccurate accounting information concerning the Fund's overhead costs. More recently, in an October 1997 report,[19] we determined that because one of the Navy's DBOF business areas did not require its customers to pay for all storage services provided its customers—as is the common practice in most businesslike operations—customers had no incentive to either relocate or dispose of unneeded ammunition and thereby reduce their costs. To the extent that the Navy's DBOF operations incur losses, future appropriations may be required to cover those losses. DOD officials informed us that they used these financial statements and related audit report findings in their efforts to reduce costs and streamline the Navy's ordnance business area.

[18]Navy Ordnance: Analysis of Business Area Price Increases and Financial Losses (GAO/AIMD/NSIAD-97-74, March 14, 1997).

[19]Navy Ordnance: Analysis of Business Area Efforts to Streamline Operations and Reduce Costs (GAO/AIMD/NSIAD-98-24, October 15, 1997).

Specific examples of problems identified by Naval Audit Service auditors in its fiscal year 1996 financial review of the Navy DBOF included the following.

- A sample comparison of inventory records and on-hand stock revealed that quantities actually in storage differed from inventory records about 22 percent of the time. The auditors reported that management took action to correct the data deficiencies it reported and that action was underway to correct the systemic causes for the discrepancies indentified. In discussing the possible implications of its findings, the Navy auditors reported that "Inaccurate inventory records distort financial records and financial reports used by senior managers. This, in turn, can result in decisions to buy wrong quantities, which could cause excesses or critical shortages of material."
- Depreciation expenses associated with fixed assets at one location were understated by a net amount of about $5 million. This occurred primarily because of a misinterpretation of guidance on reporting depreciation expenses incurred during the year on assets that were to be transferred from that location before the end of the fiscal year. While it did not quantify the extent of depreciation expense understatements, the Naval Audit Service also reported that additional reviews revealed that at least eight other locations also misinterpreted the guidance. In reporting on the implications of this deficiency, the Naval Audit Service stated, "Failure to report depreciation at closing activities understates current year costs and prior year losses that could be eligible for recoupment from Operation and Maintenance, Navy funds . . . . Ultimately, costs that are not recouped will have a direct effect on the cash position of the Department of the Navy Defense Business Operations Fund." This means that to the extent that the Navy was undercharged as a result of the depreciation understatement, the Navy would have more Operation and Maintenance funds available than it should.
- The Navy's DBOF maintained over 2,300 flatracks (containers used to transport Army cargo on Navy ships) solely for the benefit of the Army but did not recover the related estimated costs. The auditors reported that the costs to maintain these flatracks "should have been funded by Operation and Maintenance, Army funds. As a result of the failure to collect reimbursement, the Department of Navy used Operation and Maintenance, Navy funds to support the Army requirements. The funds used were estimated to be $640,000 for Fiscal Year 1997, and taking corrective action could result in the Department of the Navy putting $4.1 million to better use over a 6-year period." Although this situation did not affect the federal government's overall financial position, this means that the Navy

augmented Army budgetary resources by paying for a service that should have been paid with Army funds.

- The Navy's DBOF accounting records included at least $5.8 million in invalid "Other Non-Federal (Governmental) Liabilities." The auditors reported that "Invalid liabilities cause funds to be unnecessarily set aside either to pay invoices already paid or to plan for costs not yet incurred. Therefore, this $5,793,496 represents potential funds that can be put to better use." This means that the Navy's operation and maintenance appropriation requirements are less than previously recognized because the Navy will not be required to pay these "invalid liabilities."

Implications of Financial Statement Disclosures

Despite the shortcomings in the Navy's financial statements, we were able to identify several financial issues that may be of interest to budget and program managers. Specifically, even with the acknowledged deficiencies in the Navy's financial data, some areas raise questions about whether future budget resources may be needed or whether there may be opportunities to reduce resource requirements.

The following are examples of footnote disclosures and the kind of information that can be gleaned from them.

Figure 1: Excerpts From “Note 5. Accounts Receivable, Net”

Note 5. Accounts Receivable, Net

	(1) Gross Amount Due	(2) Allowance For Estimated Uncollectibles	(3) Method Used	(4) Amount Due
A. Entity Receivables:				
Intragovernmental	$1,928,010	$0		$1,928,010
Governmental	4,439,432	78,583	Pct.	4,360,849
B. Non-Entity Receivables:				
Intragovernmental	$117,075	$0		$117,075
Governmental	(26,673)			(26,673)

C. Other Information: The Department of the Navy does not have a Department wide allowance for estimated uncollectibles. Using the Report on Receivables Due from the Public, the overall Department of the Navy allowance was calculated to be 2.5%. In instances where historical rates exist, the chart below shows the allowances that were used.

Appropriation	Allowance
1453	14.50%
1105	3.50
1106	.01
1108	4.95

Negative Governmental Non-Entity Receivables of $26,672 thousand are a result of collections that have exceeded billings, and undistributed collections.

Figure 1 provides excerpts from the note intended to explain how the accounts receivable balance presented on the Statement of Financial Position was calculated. Accounts receivable, which represents amounts owed the Navy, is significant to program managers and budget officials. If the amount is overstated, the Navy may not receive amounts that it intended to use to support its operations and may therefore need to obtain additional funding. If the amount is understated, the Navy may lack the visibility necessary to ensure that it is taking appropriate action to collect all amounts due it.

For example, the table shows a 14.5 percent allowance for appropriation 1453 (military personnel). This means that nearly 15 percent of the funds Navy personnel owed the Navy were not likely to be collected. In some cases, better and more timely collection of these types of receivables may result in the recovery of amounts that could be used to reduce the Navy's request for funds to support its military personnel or provide funds to meet other critical resource needs.

The note also refers to negative governmental non-entity receivables of $26.7 million. A negative receivable is an unusual disclosure, indicating that the Navy does not know the source of almost $27 million it collected. These funds cannot be used until the source of the collection is determined. If these collections are owed the Navy, recording them improperly and not taking timely action to collect these amounts may have resulted in requests for budgetary resources when these collections could have been used to meet those requirements.

Figure 2: Excerpts From "Note 31. Other Disclosures"

Note 31. Other Disclosures:

The following amounts reflect the total effect of reopening of cancelled year appropriations. The balances in the entity section of the Principle Statements include amounts from cancelled years that were reopened.

Fund balance with Treasury	$3,931,344
Accounts receivable - Intragovernmental	157,540
Accounts receivable - Government	9,659
Accounts receivable - Public	(43)
Advances and prepayments	4,174
Total assets	$4,102,674
Accounts payable - Intragovernmental	$21,785
Accounts payable - Government	986,428
Accounts payable - Public	494,853
Other liabilities	1,228
Total liabilities	$1,504,294
Net position, ending balance	$2,598,380
Total liabilities	$4,102,674

Figure 2 shows excerpts from the note that provides information on over $4 billion of cancelled appropriations that the Navy reopened in fiscal year 1996. The note does not clearly indicate how much or for what purpose the cancelled accounts were used.

The Congress has long-standing concerns with agencies' use of funds after their expiration. In 1990, the Congress determined DOD was expending funds from expired accounts without sufficient assurance that authority for such expenditures existed or in ways that the Congress did not intend. To end these abuses, the Congress enacted account closing provisions in the fiscal year 1991 National Defense Authorization Act. The act closes appropriations 5 years after the expiration of their availability for obligation. Once closed, the appropriations are not available for obligation or expenditure for any purpose. In a series of decisions,[20] the Comptroller

[20]See Comptroller General Decisions 72 Comp. Gen. 343 (1993), 72 Comp. Gen. 347 (1994), and 73 Comp. Gen. 338 (1994) and B-251287.3, November 1, 1995.

General has stated, however, that agencies may adjust their accounting records for closed appropriations to record transactions that occurred but were not recorded before closure and to correct obvious clerical mistakes within a reasonable period of time after closure. For example, if an agency discovers, after an appropriation closes, that it had failed to record a disbursement that it had properly made from an appropriation before closure, the agency is expected to adjust its accounting records to reflect that disbursement.

Further details would be necessary to assess the implications of the Navy's note regarding the "reopening" of $4 billion in cancelled appropriations. This information may be related to the Navy's continuing problems in accounting for its disbursements and may indicate a weakening in the mechanism put in place by the Congress to ensure control over cancelled appropriations.

Figure 3: Note 20. Net Position

Note 20. Net Position

	Revolving Funds	Trust Funds	Appropriated Funds	Total
A. Unexpended Appropriations:				
(1)Unobligated,				
a. Available	$462,614	$2,292	$12,316,532	$12,781,438
b. Unavailable	(11,821)		3,114,817	3,102,996
(2)Undelivered Orders	3,454,591		41,637,072	45,091,663
B. Invested Capital		19,316	382,376,368	382,395,684
C. Cumulative Results of Operations		(12,421)		(12,421)
D. Other		276	56,052	56,328
E. Future Funding Requirements		(170)	(3,310,077)	(3,310,247)
F. Total	$3,905,384	$9,293	$436,190,764	$440,105,441

G. Other Information: The negative balance of $12,421 thousand in cumulative results of operations for Trust Funds pertains to the negative cumulative results of operations in the Navy Management Fund.

Navy's fiscal year 1996 Statement of Financial Position includes about $61 billion in "Unexpended Appropriations." Note 1R of the financial statements defines unexpended appropriations as "amounts of authority which are unobligated and have not been rescinded or withdrawn and amounts obligated but for which neither legal liabilities for payments have been incurred nor actual payments made." Note 20, as shown in figure 3, disclosed that at the end of fiscal year 1996, Navy had an unobligated balance available of about $13 billion and about $45 billion in undelivered orders, which represent amounts obligated but not expensed. These amounts, along with the $3 billion in unavailable unobligated appropriations included in the note, tie back to the $61 billion reported in the financial statements.

This type of information, along with other required disclosures, could serve as a key indicator of how well the Navy is managing the funds provided by the Congress. A portion of the amounts identified as unexpended appropriations relate to funding provided through procurement or other appropriations that are available for obligation for more than 1 year to fund Navy activities. However, this information, along with other required disclosures, can be used to monitor the Navy's long-standing problems in fully utilizing its resources. For example, OMB requires that agencies disclose the amount of unexpended cancelled appropriations in the note on contingent liabilities. Although the Navy's fiscal year 1996 financial statement reporting did not include this information, the Navy's year-end reports to the Treasury state that the Navy cancelled $1.8 billion and $1.5 billion in unexpended appropriations for fiscal years 1996 and 1997, respectively. Also, the Naval Audit Service has issued several reports that highlighted the Navy's ongoing problems in promptly deobligating unneeded funds that could be better utilized for critical Navy mission needs. In addition, beginning in fiscal year 1998, the Navy will be required to prepare a Statement of Budgetary Resources, which will provide decisionmakers with added information on the status of the Navy's use of its resources.

Improved Financial Statements Will Enhance Their Usefulness as a Management Tool

Although Navy officials represented their fiscal year 1996 financial statements—the first-ever attempt to prepare comprehensive financial statements for the Navy—to be based on the best information available, the usefulness of Navy's financial statement disclosures is limited at best due to the previously discussed problems with accuracy, reliability, and completeness.

The footnotes to the Navy's financial statements, which should serve as an excellent source of relevant, detailed information on its operations, are lacking in detail and present abnormal information. For example, the statements included a number of footnotes that provided only summary charts or tables or grossly abnormal balances, such as large negative balances in what would normally be expected to be accounts with positive balances, without any accompanying detail or explanation. In addition, because fiscal year 1996 was a first-year effort, the Navy's general fund financial statements do not offer the benefit of comparative data on the prior year, which can provide useful analysis on trends and changes from year to year. As the Navy and DFAS improve on their first-year efforts to develop reliable financial statements for the Navy, and when the problems identified in the auditors' reports are corrected, knowledgeable users of the Navy's financial statements will be better able to identify key issues that may be of interest to budget and program managers.

Effective Implementation of New Accounting Standards Would Provide Useful Financial Data

Recently adopted federal accounting standards are intended to enhance federal financial statements by requiring that government agencies show the complete financial results of their operations and provide relevant information on agencies' true financial status. In addition to the new requirement for the Statement of Budgetary Resources previously mentioned, two other recently adopted accounting standards are particularly significant in terms of the additional information that could be made available to Navy budget and program managers in the future, if the standards are implemented effectively. Specifically, the standards call for reporting on the Navy's costs associated with (1) the disposal of various types of assets, including environmental clean-up costs, and (2) deferred maintenance.

Issued in December 1995 and effective beginning with fiscal year 1997, Statement of Federal Financial Accounting Standard (SFFAS) No. 5, Accounting for Liabilities of the Federal Government, requires the recognition of a liability for any probable and measurable future outflow of resources arising from past transactions. The statement defines probable as that which is likely to occur based on current facts and circumstances. It also states that a future outflow is measurable if it can be reasonably estimated. Because disposal costs are both probable and measurable, they are to be reported under SFFAS No. 5. The Congress has recognized the importance of accumulating and considering disposal cost information. In the National Defense Authorization Act for Fiscal Year 1995, the Congress required DOD to develop life-cycle environmental costs, including demilitarization and disposal costs, for major defense acquisition programs. This means that the Navy is required to estimate and report, as part of the information presented in its financial statements, the estimated cost to dispose of its major weapon systems and the cost to clean up the environmental hazards found on its land and facilities.

In our recent report[21] on DOD's efforts to implement the new reporting requirements as they relate to the disposal of nuclear submarines and ships, we stated that this reported liability could be made more meaningful to decisionmakers if it was presented by approximate time periods when the disposals are expected to occur. Such information could provide important context for congressional and other budget decisionmakers on the total liability by showing the annual impact of disposals that have already occurred or are expected to occur during the budget period. Furthermore, if the time periods used to present these data were consistent with the timing of when funding was being requested for disposal costs as reflected in budget justification documents, such as DOD's Future Years Defense Program, this type of disclosure would provide a link between budgetary and accounting information, one of the key objectives of the CFO Act.

In addition, SFFAS No. 6, Accounting for Property, Plant, and Equipment, issued November 30, 1995, and effective beginning with fiscal year 1998, requires recognition of deferred maintenance amounts by major class of asset along with disclosure of the method used to measure the extent of deferred maintenance needed for each asset class. In our recent report[22] on DOD's efforts to implement this standard as it relates to Navy ships, we stated that accurate reporting of deferred maintenance is important for key decisionmakers such as the Congress, DOD, and Navy managers and can be an important performance indicator of mission asset condition, which is a key readiness factor. While the existence of deferred maintenance may indicate a need for additional resources for maintenance, such resources may already be available within the current funding of the military services.

As Navy and DFAS move to put in place the systems and procedures required to comply with these new accounting standards, they will not only be better able to prepare a more useful set of Navy financial

[21]Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997).

[22]Financial Management: Issues to Be Considered by DOD in Developing Guidance for Disclosing Deferred Maintenance on Ships (GAO/AIMD-98-46, February 6, 1998).

statements but also to better support more informed programmatic and budgetary decision-making in these areas.

Conclusions

Currently, the Navy is unable to produce accurate financial information needed to support either its financial statements or operations and budgetary decision-making. However, through the impetus provided by the CFO Act, it has an opportunity to better integrate financial information into budget and operational management decisions. To seize this opportunity, the Navy and DFAS must establish a greater linkage between financial statement preparation and reporting processes, and resource allocation and oversight decisions. However, such a linkage will yield the benefits envisioned by the CFO Act only if the Navy's financial information is dramatically improved to the point where it is generated by a systematic process and its accuracy can be verified. Auditable financial statements produced by this type of disciplined process provide the Congress and managers with assurance that the information being used to support the statements is accurate and can therefore be used with confidence for day-to-day decision-making.

In this context, efforts to produce auditable financial statements on an annual basis should be viewed not as an end in itself but as the capstone of a vigorous financial management program supported by effective information systems that produce accurate, complete, and timely information for decisionmakers throughout the year. Achieving the far-reaching financial management goals established by the CFO Act, particularly in light of the serious and widespread nature of the Navy's long-standing financial problems, will only be possible with the sustained, demonstrated commitment of top leaders in DOD, the Navy, and DFAS.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD stated that it is firmly committed to providing taxpayers and the Congress with accurate financial statements that can pass rigorous audit tests. DOD also said that for some time it has acknowledged that significant improvements are required in its financial management systems and reporting, and that many of the problems found during the audits of the Navy's fiscal year 1996 financial statements remain. It also stated that financial management is a high priority in DOD and that it is working to improve the basic financial procedures and systems used to collect, categorize, and report financial transactions.

DOD expressed concern with what it termed the report's implication that the Navy's budget is overstated or could be reduced because its financial statements omitted a line, excluded a footnote, or were otherwise deficient. DOD stated that such an implication is grossly misleading and undermines the rigorous planning, programming, and budgeting process within both DOD and the Navy. In addition, DOD maintained that the report leaves the erroneous impression that there have been no significant improvements in the Navy's financial operations since our review of the Navy's fiscal year 1986 financial reports. Furthermore, DOD stated that the report makes broad assertions that deficiencies in the Navy's financial statements adversely impact the ability to make informed programmatic and budgetary decisions. In this regard, DOD contended that the report did not acknowledge that many of the deficiencies cited, including those from audit reports, are reviewed as part of the Navy's day-to-day management and internal budget review processes, and again by the Office of the Secretary of Defense.

We disagree that our report implies that the Navy's budget is overstated or could be reduced merely because data were omitted from the Navy's financial statements or because the statements were deficient in some other way. Our report focuses on deficiencies in the management systems and processes that are used to support not only the Navy's financial statement preparation, but its budgetary and program decision-making. As a result, the deficiencies discussed in our report focus on those errors or omissions in the Navy's financial reporting that also raise serious questions about whether decisionmakers had sufficiently reliable information available to make informed budgetary resource allocation decisions.

With respect to DOD's assertion that our report provides a misleading impression that there have been no significant improvements in Navy's financial operations, our finding that the Navy has been plagued with troublesome financial management problems for many years is warranted. We have not seen the level of expected improvement in the years that have passed since our report on the Navy's fiscal year 1986 financial reporting. While we are encouraged with DOD's stated high priority commitment to reforming its financial operations, significant errors, omissions, and misstatements remain uncorrected, as evidenced by the extent and nature of the deficiencies pointed out in auditors' reports on their examination of the Navy's fiscal year 1996 financial statements. Efforts to reform DOD's financial operations, however well-intentioned, have not as yet resulted in the level of improvements needed to put in place a disciplined financial operation that will not only yield accurate, reliable information for the Navy's financial statements, but also support its program and budget decision-making. It is for this reason that DOD financial management is on our list of high-risk government programs.[23]

Lastly, we are encouraged that the Navy auditors' findings have been used and that the Navy has found them helpful in developing budget estimates. In addition, while the Navy's planning, programming, and budgeting process was not the focus of the review requested for this report, we recognize that it has been in place for many years and is intended to provide a thorough review of all pertinent information, including the implications of auditors' findings, in determining Navy budget estimates. However, the Navy should not be forced to rely on such alternative data development and validation procedures as a proxy for a systematic, disciplined financial management and reporting process. Such a process would provide accurate and reliable financial data to support the development of the Navy's financial statements, as well as day-to-day program and budget decision-making.

We are sending copies of this report to the Ranking Minority Member of the House Committee on the Budget, the Director of the Office of Management and Budget, the Secretary of Defense, the Secretary of the Navy, and the Director of the Defense Finance and Accounting Service. We will also send copies to other interested parties upon request.

Please contact me at (202) 512-9095 if you or your staff have any questions concerning this report. Major contributors are listed in appendix IV.

Sincerely yours,

Lisa G. Jacobson
Director, Defense Audits

[23] High-Risk Series: Defense Financial Management (GAO/HR-97-3, February 1997).

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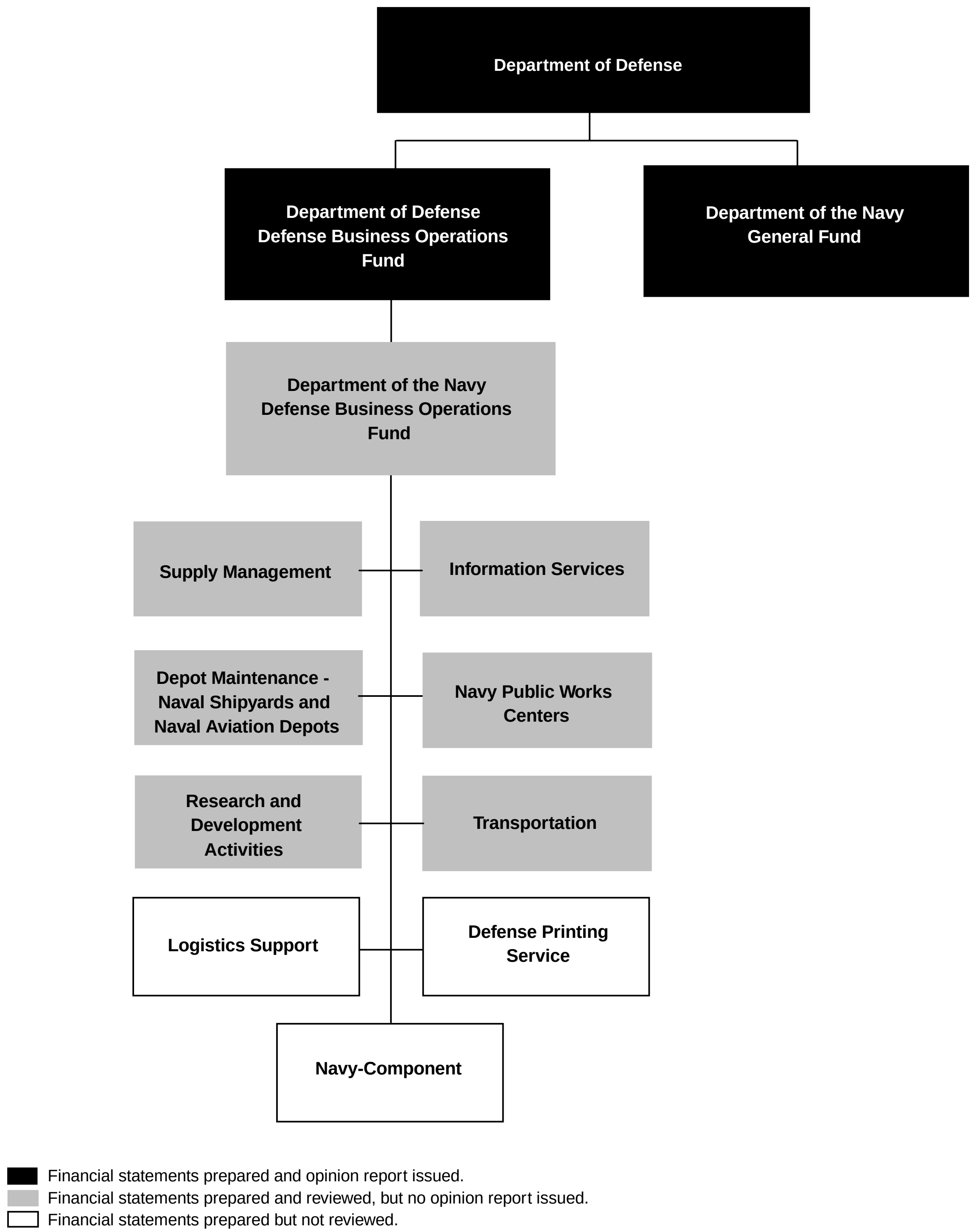
Abbreviations

CFO	Chief Financial Officer
DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DOD	Department of Defense
FASAB	Financial Accounting Standards Advisory Board
OMB	Office of Management and Budget
SFFAS	Statements of Federal Financial Accounting Standards

Audit Status of Navy Entities for Fiscal Year 1996



Naval Audit Service Reports Resulting From Fiscal Year 1996 Audit

General Fund Reports

Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Auditor's Opinion (Report No. 022-97, March 1, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Report on Internal Controls and Compliance with Laws and Regulations (Report No. 029-97, April 15, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Fund Balance with Treasury and Cash and Other Monetary Assets (Report No. 004-98, October 31, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Property, Plant, and Equipment, Net (Report No. 051-97, September 25, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Government Property Held by Contractors (Report No. 046-97, August 14, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Ammunition and Ashore Inventory (Report No. 048-97, September 25, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Advances and Prepayments, Non-Federal (Report No. 049-97, September 19, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Accounts Receivable, Net (Report No. 045-97, August 12, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Accounts Payable and Accrued Payroll and Benefits (Report No. 006-98, November 14, 1997).

Department of the Navy Fiscal Year 1996 Annual Financial Report: Department of Defense Issues (Report No. 015-98, December 19, 1997).

Defense Business Operations Fund Report

Fiscal Year 1996 Consolidating Financial Statements of the Department of the Navy Defense Business Operations Fund (Report No. 040-97, June 16, 1997).

Comments From the Department of Defense

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

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

MAR 9 1998

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 response to the General Accounting Office (GAO) Draft Report, "CFO ACT FINANCIAL AUDITS: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies," dated February 19, 1998, (GAO Code 918928) OSD Case 1548.

Annual Chief Financial Officer financial statements represent the summarization of data collected and reported by various financial and nonfinancial systems. The Department is firmly committed to providing the taxpayers and the Congress with accurate Chief Financial Officer financial statements that pass the tests of rigorous audit. However, the Department has for some time acknowledged that significant improvements are required in its financial management systems and reporting to fully achieve this objective. Financial management reform is a high priority for the Department, and the Department is working to improve the basic financial procedures and systems that are used to collect, categorize and report financial transactions.

See comment 1.

The subject report focuses on deficiencies that were found during audits of the Navy's FY 1996 financial statements. While many of the problems have not yet been fully resolved, there have been significant improvements. Unfortunately, the draft report leaves readers with the erroneous impression that nothing has changed. In addition, the Department does not believe that some of the GAO's assertions accurately reflect the facts. Enclosed are detailed comments on specific items contained in the draft report.

The draft report makes numerous broad assertions that deficiencies in the Department of the Navy's prior year financial statements adversely impact the ability to make informed programmatic and budgetary decisions. The draft report is silent with regard to the budget process and overlooks the fact that many of the examples cited, such as previous audit reports, accounting information, appropriation balances, and other information are reviewed, and modified as appropriate, as part of the Navy's day-to-day management processes, its internal budget review processes and again by various staff elements of the Office of the Secretary of Defense.

See comment 1.

The Department of the Navy's internal budget review procedures provide for a thorough examination of all pertinent GAO, Naval Audit Service and DoD Inspector General reports in conjunction with the Navy's internal budget review. Those "audit findings" with valid resource savings are incorporated in the Navy's budget estimates, where it is appropriate to do so. To imply that the Navy's budget is overstated or could be reduced because Chief Financial Officer financial statements for previous years omit a line, exclude a footnote, or otherwise are deficient is misleading and ignores the rigorous planning, programming and budget processes that exist within the Department of the Navy and the Department of Defense. Such misleading implications are a disservice not only to the Department of Defense, but also to the Congress.

The Department appreciates the opportunity to comment on the draft report.

Sincerely,

Alice C. Maroni
Principal Deputy Under
Secretary of Defense (Comptroller)

Enclosure

GENERAL ACCOUNTING OFFICE DRAFT REPORT
"CFO ACT FINANCIAL AUDITS: PROGRAMMATIC AND BUDGETARY IMPLICATIONS OF NAVY FINANCIAL DATA DEFICIENCIES," DATED FEBRUARY 19, 1998
(GAO Code 918928) OSD Case 1548

DEPARTMENT OF DEFENSE COMMENTS ON THE DRAFT REPORT

The Department of Defense (DoD) acknowledges that much work is required to improve the Department's financial management procedures, systems, and reporting. This work is required in both financial systems as well as nonfinancial systems that provide feeder data to the financial systems. However, the GAO's effort merely to consolidate, into a single report, previous audits going back as far as 1986 does not result in a fair representation of the current status of the Department of the Navy's financial reports.

See comment 2.

The subject draft GAO report relied heavily on information provided in the financial statement audit reports issued by the Naval Audit Service (NAS). Both the Under Secretary of Defense (Comptroller) and the Defense Finance and Accounting Service (DFAS) provided comments on those reports that do not appear to have been considered by the GAO during the preparation of this report. The comments provided to the NAS identified weakness in the findings reported by the NAS in its audits of the FY 1996 financial statements, including the findings involving Operating Materials and Supplies and the Fund Balance with Treasury.

See comment 1.

See comment 3.

Also, the GAO's reference to a report on the Department of the Navy's fiscal year 1986 financial reports is misleading, and implies that no progress has been made in improving the Navy's financial reports during the last 11 years. In addition, there have been significant new financial reporting requirements imposed as a result of the Office of Management and Budget's issuance of the Statements of Federal Financial Accounting Standards (SFFASs). Since DoD's financial reform initiatives were undertaken a little over 4 years ago, significant progress has been achieved in improving Navy's financial statements.

Now on p. 2.

See comment 4.

See comment 5.

Page 4, first paragraph, second sentence: The paragraph cites a GAO report that reported contractors voluntarily returned checks to DoD totaling about $1 billion per year for FY 1994 through FY 1996. It must be noted that the DFAS reports the amount of checks returned by contractors for all of FY 1997 was reduced to just over $100 million. The wording of the draft report implies that these returned checks all apply to Navy funds. The reader is not informed of two very important facts: (1) the returns involved funds from all of the Military Departments and many of the Defense Agencies--not just the Navy and (2) a significant amount of the returned funds resulted from changes in the contract requirements or prices that occurred after progress payments had been properly issued--and were not due to errors or deficiencies in the Navy's financial systems.

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Now on p. 8.

See comment 6.

Page 13, third paragraph: The GAO cites the following incorrect NAS finding: "The Department of the Navy did not report an estimated $7.8 billion in Operating Materials and Supplies aboard ships or with Marine Corps activities on the FY 1996 Statement of Financial Position." The NAS is correct in that $7.8 billion of materials and supplies on-board ships were not reported as Operating Materials and Supplies. However, the NAS and the GAO are incorrect in calling this a financial reporting error. The items in question need not be reported as Operating Materials and Supplies. In accordance with the reporting options cited in the SFFAS No. 3 "Accounting for Inventory and Related Property," reporting entities are permitted to use the consumption method for accounting for Operating Materials And Supplies aboard ships and for Marine Corps units since these operating materials and supplies were considered to be in the hands of the end user. Under the purchases method, Operating Materials and Supplies is expensed when purchased. The Navy's financial reports correctly reflected the treatment of such items.

See comment 1.

Additionally, the GAO implies that including this $7.8 billion on the Operating Materials and Supplies line in an annual financial report will directly affect the Navy budget preparation/request for inventory items. Decisions on inventory and supply purchases are not made based on the figures reported in the Chief Financial Officer financial statements of previous years. Decisions concerning the types and quantities of inventory items to be purchased are based on much more detailed information, such as consumption and stock-level data, that is obtained from supply and inventory systems.

Now on p. 9.

Page 16, paragraph 2: The GAO cites the following incorrect NAS finding: "The Department of the Navy could not effectively account for the balances in the Fund Balance with Treasury because Defense Finance and Accounting Service-Cleveland Center had not developed an adequate accounting system to do so. Consequently, the Department of the Navy cannot provide reasonable assurance that: …the $64.8 billion account balance reported on the FY 1996 Statement of Financial Position presents fairly its financial position…"

The DFAS disputed this finding and provided comments on October 15, 1997, to the Auditor General of the Navy. To date, the NAS has offered no response to those comments regarding the practice and procedures currently in-place to record and accurately report Fund Balance with Treasury in the Cleveland network. The DFAS believes the NAS's finding stems principally from a misunderstanding (or at best an incomplete understanding) of the data sources and procedures used for determining Navy Fund Balance With Treasury.

See comment 7.

The GAO cites a continuation of the above incorrect NAS finding: "Defense Finance and Accounting Service principally used Department of the Treasury data in reporting the Fund Balance with Treasury because the data was considered more reliable than the data provided by the Navy's accounting system." The DFAS nonconcurred with this finding and presented its arguments in the aforementioned memorandum. The statement, as written, implies that DFAS-Cleveland Center uses Treasury information because it is more accurate than the data provided by the Department of the Navy and DFAS systems. As has been explained to the NAS, summarized data from Department of the Navy and DFAS systems are first obtained and then reconciled to Treasury data in accordance with DoD policy and Department of Treasury guidance. The DoD is the major source of this Treasury data. The differences in question are

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those between (1) amounts reported at the Departmental level and reported to Treasury and (2) the amounts recorded in the accounting records at the activity level. These differences are termed "undistributed collections and disbursements." Undistributed collections and disbursements recognize the reality that some collections and disbursements made by others have not been recorded in the accounting records of individual activities as of the end of the accounting period. However, these undistributed collections and disbursements are recorded in the Departmental [Navy] level accounting records and included in the Navy's financial reports.

Now on p. 10.

Page 17, paragraph 2: The GAO states that "Because the Navy does not properly record all of its disbursements, it has no assurance that it will have enough funding available to pay for its expenses." The DoD records obligations when orders are placed, before, or at the time that, liabilities are incurred. Payments generally are not made until later. The Department has acknowledged that there are some problems with the matching of disbursements to the correct obligation records in the accounting systems. Significant work has been accomplished and more is underway to correct the systemic deficiencies and resolve the existing mismatches. The GAO's wording may be incorrectly interpreted to imply that payments are issued without regard to the recording of obligations. The Navy as well as other DoD activities record obligations as orders are issued, prior to the event that represents incurrence of a liability or a requirement to make payment.

See comment 8.

The GAO draft report also stated that "Cleveland Center had not developed an adequate accounting system" to account for the fund balance with Treasury. However, the GAO failed to indicate that the DFAS is developing and recommending interim migratory systems in concert with its customers, not making unilateral decisions. This is important because most of the financial data originates within the Department of the Navy, not the DFAS.

See comment 9.

Now on p. 10.

Page 17, second paragraph: The "checkbook" analogy cited is misleading and overly simplified because it fails to acknowledge that DoD activities record obligations when orders are placed and that those obligations represent the basic control that ensure fund balances are not exceeded. Federal accounting requirements involve more than maintaining a simple cash balance as in a personal checkbook.

See comment 10.

Now on p. 10.

Page 18, first paragraph: The GAO states that the lack of controls over the fund balance with Treasury may result in Antideficiency Act violations. The GAO then cites some statistics regarding Antideficiency Act violations incurred by the Navy during the period of 1993 through 1995. The report implies that those violations are caused by a lack of controls over fund balance with Treasury. A review of the actual Antideficiency Act violations shows that *none* of the violations resulted from erroneous fund balance with Treasury figures. In 9 of the 15 cases, Navy officials used operation and maintenance funds to procure items that should have been purchased with investment or research and development funds. In another case, investment funds were used to purchase items that should have been funded with operation and maintenance funds. In the remaining four cases, inadequate controls over unobligated balances at the activity level led to the violations. The GAO's interpretation and subjective assertions are unfounded, misleading and result in incorrect interpretations of data in other reports.

See comment 11.

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Now on p. 10.

See comment 12.

Page 19, first paragraph: The GAO reports the NAS identified $2.5 million in duplicate or erroneous payments that had not been previously identified by the DFAS operating locations for collection. While the DFAS concurs that some erroneous and duplicate payments occurred, the DFAS nonconcurs with the amount asserted. In some cases, the identified payments were not, in fact, duplicate or erroneous payments and, in other cases, the erroneous payments had been identified and collected prior to the NAS audit.

Now on p. 18.

See comment 13.

Page 29, paragraph 2: The GAO report indicates that the footnote on the reopening of canceled accounts may indicate a weakening in the mechanism put in place by the Congress to ensure control over canceled appropriations. This statement is made without any objective evidence that such a weakening has or will occur. The footnote merely reflects that some adjustments had to be made to certain canceled accounts. None of the adjustments provided funds to make additional disbursements. All of the adjustments were made to correct disbursement-posting errors--that occurred prior to cancellation of the accounts--in the effected canceled accounts. Both the Department of Treasury and the GAO have recognized the need for such adjustments. In addition, those corrections are required in order for the DoD to adhere to the provisions of Section 1553 of title 31 United States Code relating to charges which may be made to current accounts after an account has been closed. This tracking process is intended to ensure that, for canceled appropriations, the original appropriated amount is not exceeded by delaying the posting of disbursements or obligations until after the cancellation of the account. Agencies are required to report an Antideficiency Act violation if the unliquidated or unobligated balances are ever exceeded, and are required to include in this calculation any amounts charged to current accounts after the applicable account in question has been cancelled. Therefore, it is necessary for the Department to maintain, and keep, in perpetuity, accurate, records for canceled accounts.

Now on p. 19.

See comment 14.

Page 31, paragraph 2: The GAO makes the statement, "In addition, beginning in FY 1998, the Navy will be required to prepare the Statement of Budgetary Resources, which will provide decision makers with added information on the status of the Navy's use of its resources." The information provided in the Statement of Budgetary Resources currently is available to congressional and Navy decision-makers on the Report on Budget Execution, SF 133. Each line on the Statement of Budgetary Resources relates directly to a line on the SF 133. Thus, the Statement of Budgetary resources is not expected to provide any information not currently available. Further, this information currently is available, and is provided, much more frequently than annually—which is the requirement for Chief Financial Officer financial statements.

Now on p. 20.

See comment 15.

Page 32: The GAO reports that the "footnotes to the Navy's (FY 1996) financial statements are lacking in detail and present abnormal information." Further, the GAO states that DFAS-Cleveland used a "number of footnotes with summary charts or tables or grossly abnormal balances without any accompanying explanation." The Department acknowledges that FY 1996 was the first year that the Department of the Navy prepared audited financial statements and that more comprehensive disclosures could benefit users. The Navy and the DFAS have made significant improvements during FY 1997 but more work remains. It must be noted, however, that the form and content of the financial statements, including the format of the tables and exhibits in the notes to the financial statements, are prescribed by the OMB in its Bulletins 94-19 and 97-01, "Formats and Instructions for the Form and Content of Agency Financial

Statements," not by the Department of the Navy or even the DoD. It should be made clear that suggestions for significant changes in the content of the statements or the accompanying notes should be addressed to the OMB.

See comment 16.

Page 34, paragraph 2: The GAO draft report states: "The Naval Audit Service reported that the Navy's fiscal year 1996 reporting did not recognize a liability for projected environmental cleanup costs of $7.1 billion." The GAO perpetuates the incorrect NAS statement without qualification. The GAO draft report fails to disclose that the amounts not reported on the Statement of Financial Position for FY 1996 were not required to be reported on that statement. The NAS statement apparently was based on an incomplete understanding of the implementation schedule for the SFFAS No. 5, "Accounting for Liabilities of the Federal Government." The SFFAS No. 5 requirements concerning the reporting of cleanup costs became effective for fiscal years beginning after September 30, 1996 (FY 1997 and thereafter). Thus, those requirements were not in effect for FY 1996. However, the Navy's FY 1996 financial statements did fully disclose—in Footnote 30, Contingencies—projected environmental clean-up costs in a manner fully consistent with the guidance provided at the time by the OMB and DoD.

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The following are GAO's comments on the Department of Defense's letter dated March 9, 1998.

GAO Comments

1. See the "Agency Comments and Our Evaluation" section of this report.

2. Our analysis of the Naval Audit Service reports considered the Under Secretary of Defense (Comptroller) and Defense Finance and Accounting Service comments that were included in the reports.

3. As stated in the report, the Navy, like all other federal entities, has been required to prepare and submit a prescribed set of financial information to the Treasury since 1950. In addition, the federal financial accounting standards to which DOD refers were, for the most part, not required or implemented in the fiscal year 1996 statements. We refer to these standards only in the report's discussion of financial data that will be available when DOD fully implements these provisions.

4. The report was revised to indicate that the checks returned to DFAS applied not only to the Navy, but also to the other military services and Defense agencies.

5. To ensure proper payment, financial management personnel are dependent upon obtaining accurate and complete contract information. To the extent that the financial systems do not contain accurate and complete information from feeder systems or the feeder systems provide erroneous information on, for example, contract modifications, overpayments can occur.

6. As discussed in our August 1996 report, we disagree that operating materials and supplies held on board ships are considered to be in the hands of end users. These items should be reported on the Navy's financial statements as operating materials and supplies. In addition, we agree that decisions on inventory purchases are not based on amounts reported in the Navy's financial statements (or, as in the case of the $7.8 billion in operating materials and supplies, amounts excluded from the statements). However, as discussed in our report, the Navy auditors and we have found deficiencies in the management systems and processes which are used not only to support the inventory values included in the Navy's financial statements, but also to support the Navy's budgetary and program decision-making concerning needed inventories. As a result, the deficiencies discussed in our report concern not just errors or omissions

in the Navy's financial reporting, but also raise questions about whether decisionmakers had sufficiently reliable information available on which to make informed budgetary resource allocation decisions.

7. Undistributed collections and disbursements represent amounts reflected in Treasury's records but not recorded by the Navy. The Navy then recorded these amounts in its department-level accounting records without having corroborating support in the form of transaction detail needed to verify that these amounts accurately represent Navy activities. As a result, the Navy does not know whether its records are accurate.

8. While DOD has efforts underway that are intended to match disbursements against valid obligations before payment, this is not currently required for all payments. Consequently, until DOD can establish controls to ensure that all disbursements can be related to a valid obligation at the time of payment, DOD cannot rely on its obligation records for funds control purposes and will continue to lack assurance that it will have sufficient funding available to pay its expenses.

9. DOD's comment concerning an adequate accounting system at the DFAS Cleveland Center relates to a quote from a Naval Audit Service report and has no impact on the point being made in our report.

10. We disagree that simply recording obligations ensures that fund balances are not exceeded. DOD, under law, must maintain accurate and reliable obligation and disbursement records. The Antideficiency Act prohibits not only overobligations but overexpenditures as well. Obligated balances forecast expenditures and, in that regard, offer some measure of funds control by, in effect, "setting aside" funds for these projected amounts. However, even if all obligations have been recorded, actual expenditures can be more (or less), making it necessary to adjust obligated amounts when payment occurs. By not matching payments to obligations at the time of disbursement, the Navy has undermined this control feature.

11. The report was revised to omit reference to the specific Antideficiency Act violations previously reported by the Navy.

12. The report was revised to indicate that DOD officials stated that the entire $2.5 million discussed in the Naval Audit Service report may not represent erroneous or duplicate payments.

13. After an appropriation cancels, Public Law 101-510 permits agencies to liquidate obligations that had been properly charged to the appropriation during its period of availability. However, the liquidation must be from current funds available for the same purpose, and the agency may not charge expenditures against such accounts in excess of the lesser of 1 percent of that appropriation or the unexpended balance of the cancelled appropriation. To track compliance with these limitations, agencies need to maintain in their records for the cancelled appropriation memorandum account entries to track transaction amounts.

We do not agree that maintaining memorandum account balances requires the reopening of cancelled accounts, as implied by DOD's comments. Public Law 101-510 prohibits agencies from using cancelled appropriations for any purpose whatsoever. As indicated in our report, reopening cancelled accounts provides an opportunity for an agency to inappropriately charge current disbursements against reopened cancelled appropriations, thereby weakening the controls the Congress established in Public Law 101-510.

14. While information on the status of the Navy's use of its resources is currently available, it has not been audited. Only when this information is compiled through a disciplined process that can withstand the rigors of a financial audit test will congressional and Navy decisionmakers have assurance that this information is accurate and reliable.

15. We agree that OMB is responsible for providing minimum guidance for all agencies to follow in preparing their financial statements. However, it remains the responsibility of each agency to expand on these minimum requirements, as appropriate, so that its financial statements (1) provide sufficiently detailed information on the unique circumstances and operations of that agency and (2) are most relevant and informative for oversight officials and other users.

16. While the Navy was required to record a liability for certain environmental cleanup costs based on existing accounting standards at the date of the financial statements, this report addresses audited information that will be available upon full implementation of the federal financial accounting standards. As a result, the report was revised to delete reference to a Naval Audit Service finding concerning reporting a projected environmental cleanup cost liability.

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