

*Audit*



*Report*

SUMMARY REPORT ON FINANCIAL REPORTING  
OF GOVERNMENT PROPERTY IN THE CUSTODY  
OF CONTRACTORS

Report No. 99-013

October 15, 1998

Office of the Inspector General  
Department of Defense

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### **Acronyms**

AAA	Army Audit Agency
AFAA	Air Force Audit Agency
CPMS	Contract Property Management System
DFAS	Defense Finance and Accounting Service
DISA	Defense Information Systems Agency
DLA	Defense Logistics Agency
DNA	Defense Nuclear Agency
GAO	General Accounting Office
IG	Inspector General
IPT	Integrated Process Team
MOCAS	Mechanization of Contract Administration Services



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

October 15, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Summary Audit Report on Financial Reporting of Government Property in  
the Custody of Contractors (Report No. 99-013)

We are providing this audit report for your review and comment. This audit was performed in response to the Chief Financial Officers Act of 1990 requirement for financial statement audits.

We considered the management comments received in preparing this report. The complete text of the comments is in Part III. The comments were responsive to the intent of the recommendations and no further response is necessary.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Brian M. Flynn at (703) 604-9145 (DSN 664-9145) (bflynn@dodig.osd.mil) or Ms. Linda A. Pierce at (216) 522-6091 (DSN 580-6091), extension 234, (lap@dodig.osd.mil). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in black ink that reads "Robert J. Lieberman".

Robert J. Lieberman  
Assistant Inspector General  
for Auditing



## Office of the Inspector General, DoD

Report No. 99-013  
(Project No. 6FI-2009.02)

October 15, 1998

### Summary Report on Financial Reporting of Government Property in the Custody of Contractors

#### Executive Summary

**Introduction.** This report summarizes the weaknesses identified by a DoD-wide audit performed by the Inspector General, DoD; Army Audit Agency; Naval Audit Service; and Air Force Audit Agency on the financial reporting of Government property in the custody of contractors. The reported amount of Government property in the custody of contractors has remained around \$90 billion (acquisition value) over the last 3 fiscal years. Since our review of the Contract Property Management System and the FY 1996 DoD financial statements, financial managers in each Military Department have adjusted the way data from the Contract Property Management System are used for financial reporting. However, the system and the way the data are entered into financial statements have not changed. The amount of Government property in the custody of contractors remains material to the DoD financial statements, and the National Defense line on the Government-wide financial statements is material to the Consolidated Financial Statements of the United States. The inability of DoD to resolve the reporting of Government property in the custody of contractors will impede the ability of the DoD and the Federal Government to obtain a favorable opinion on future financial statements.

**Audit Objective.** The overall audit objective was to determine whether account balances for Government property in the custody of contractors were complete, accurate, and included in the financial statements of the Military Departments and Defense agencies. We also assessed management controls affecting the financial reporting of Government property and compliance with applicable laws and regulations.

**Audit Results.** The DoD financial statements for FYs 1996 and 1997 did not accurately report Government property in the custody of contractors. Although the Contract Property Management System does report Government property, financial statement requirements are not met because the system: does not apply capitalization thresholds; does not compute depreciation; does not distinguish between assets of the General Fund and the Working Capital Fund; and does not provide data in time to meet financial statement reporting milestones. Auditors were not able to verify the \$92 billion of Government property that contractors reported in their possession for FY 1996. Consequently, we could not express an opinion as to whether the Government property in the custody of contractors reported in DoD financial statements was complete and

accurate. Similar problems occurred in financial reporting for FY 1997, and can be expected in FY 1998. These problems constitute a continuing material management control weakness. See Part I and Appendix A for details.

**Summary of Recommendations.** In the first report of this series, Inspector General, DoD, Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997, we recommended that the Under Secretary of Defense (Comptroller) form a working group to develop solutions to the financial issues involving Government property (see Appendix B for details). In addition, we recommended that the Under Secretary of Defense (Comptroller) cite the financial reporting of Government property as a DoD material weakness in the Annual Statement of Assurance. We reiterated the need for those actions in the draft of this report.

**Management Comments.** The Under Secretary of Defense (Comptroller) nonconcurred with forming a working group, on grounds that it would be contrary to the Defense Reform Initiative, but asserted that the financial reporting of Government property would be addressed in proposals then known as the Alternative Methodologies. The Under Secretary of Defense (Comptroller) partially concurred with the recommendation to cite the financial reporting of Government property as a DoD material weakness in FY 1998, stating that the Government property area was reported in FY 1997 as a material weakness and did not need to be reported as a new material weakness in FY 1998. See Part I for a discussion of management comments and Part III for the complete text of management comments.

**Audit Response.** We disagree that forming a working group would have been contrary to the direction of the Defense Reform Initiative and note that we have been requested to participate in several new DoD team problem solving initiatives over the past few months. Nevertheless, the Alternative Methodologies initiative, now known as the DoD Proposed Implementation Strategy, appears to be a viable approach for moving this issue forward, so long as a way can be found to ensure active participation by the Under Secretary of Defense (Acquisition and Technology). Therefore, we accept the management comments as being responsive to the intent of the recommendations. The same is true for the comments on reporting an management control weakness. Our point was that Government property needed to continue being identified as a material control weakness. No further comments are required.

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## **Part I - Audit Results**

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## **Audit Background**

Public Law 101-576, the “Chief Financial Officers Act of 1990,” as amended by Public Law 103-356, the Federal Financial Management Act of 1994, requires the annual preparation and audit of financial statements for trust funds, revolving funds, and substantial commercial activities of 23 executive departments and agencies, as well as Government corporations. The Chief Financial Officers Act also requires the Inspectors General, or appointed external auditors, to audit financial statements in accordance with generally accepted Government auditing standards and other standards established by the Office of Management and Budget.

**Federal Acquisition Regulation Requirements for Government Property.** The Federal Acquisition Regulation, Part 45, “Government Property,” establishes guidance for providing Government property to contractors, and specifies that Government property in the custody of contractors is property owned by or leased to the Government or acquired by the Government under the terms of the contract. Contractors are ordinarily required to furnish all property necessary to perform Government contracts. However, the Government may either provide property to the contractor or allow the contractor to purchase property to complete contract work when in the best interests of the Government. In this report, we use the term “Government property” to refer to all Government-owned property in the custody of contractors, whether furnished to contractors by the Government or acquired by contractors for the Government. The Federal Acquisition Regulation also holds contractors accountable for Government property in their custody and (with certain exceptions) requires contractors to maintain the official Government property records. The Government is prohibited from maintaining duplicate property records. Defense contractors annually report the amount of Government property on the Defense Department Form 1662, “DoD Property in the Custody of Contractors.” DoD personnel review and enter the Government property data from the Defense Department Form 1662 into the Contract Property Management System (CPMS). The CPMS is a DoD system that provides an annual snapshot of Government property balances as of September 30 each year.

**Financial Reporting Requirements for Government Property.** Federal Financial Accounting Standard Number 6, “Accounting for Property, Plant, and Equipment,” November 1995, requires general property, plant, and equipment to

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be recorded at acquisition cost, capitalized in accordance with capitalization criteria, and depreciated. The standard includes Government property in the custody of contractors as part of property, plant, and equipment.

## **Audit Objectives**

The overall audit objective was to determine whether account balances for Government property in the custody of contractors were complete, accurate, and included in the financial statements of the Military Departments and Defense agencies. We also assessed management controls affecting the financial reporting of Government property and compliance with applicable laws and regulations.

This is the final report in a series on Government property in the custody of contractors. This report summarizes the weaknesses identified by the IG, DoD, and the Military Department audit agencies on the financial reporting of Government property in the custody of contractors.

Appendix A discusses the audit scope, methodology, management control program, and other prior coverage related to the audit objectives. Appendix B summarizes audit reports produced from the DoD-wide audit by the IG, DoD; Army Audit Agency; Naval Audit Service; and Air Force Audit Agency.

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## **DoD Issues With Financial Reporting of Government Property in the Custody of Contractors**

The DoD financial statements for FYs 1996 and 1997 did not accurately report Government Property in the Custody of Contractors. This material weakness in DoD financial management was documented for FY 1996 financial statements in audit reports issued by the IG, DoD; Army Audit Agency; Naval Audit Service; and Air Force Audit Agency. The audits documented the following conditions.

- o Approximately \$12 billion of CPMS data reviewed (used in financial reporting) contained about \$962 million in aggregate errors.
- o Fixed asset lines in the Army financial statements which incorporate the value of Government property in the possession of contractors--an aggregate reported amount of \$14.1 billion--were materially misstated and unauditible.
- o A \$21.4 billion unreconciled difference existed between Air Force financial statement and contractor reported balances for Government property in the possession of contractors.
- o About \$32.7 billion of Government property in the possession of contractors reported in the Navy financial statements contained significant misstatements and was not supported by accurate accounting data.
- o The American Forces Information Service, Defense Information Systems Agency, and the Defense Special Weapons Agency did not report Government property in the custody of contractors, misstating the financial statements by at least \$171 million.

DoD had not developed clear guidance on how Government property data should be captured and reported, and DoD had not established a standard system to meet financial statement reporting requirements. Auditors were not able to verify the \$92 billion (acquisition cost) of Government property that contractors reported in their possession for FY 1996; consequently, the auditors could not attest to the accuracy of the Government property in the custody of contractors reported in DoD financial statements. Because minimal action has been taken to resolve the problems, similar problems occurred for FY 1997 and can be expected for FY 1998 and beyond.

## **Government Property Reporting Requirements**

Both the acquisition and finance communities have established reporting requirements for Government property in the custody of contractors. However, the data used for property administration purposes do not meet financial statement reporting requirements.

**Acquisition Reporting of Government Property.** The acquisition community requires reporting property data (through CPMS) primarily for property accountability purposes. The data consist of summary totals for nine categories of property as of September 30 each year. The CPMS is the only system that reports Government property. Although the system may be adequate for acquisition purposes, the CPMS is not adequate for reporting Government property balances on the financial statements.

**Financial Statement Reporting of Government Property.** The DoD financial community requires reporting property data for financial statement purposes. Federal Financial Accounting Standards require Government property to be recorded at acquisition cost, capitalized in accordance with capitalization criteria, and depreciated. In addition, DoD requires assets to be distinguished between the General Fund and the Working Capital Fund. DoD does not have accounting systems that comply with these requirements. Although CPMS does report Government property, financial statement requirements are not met because the system: does not apply capitalization thresholds; does not compute depreciation; does not distinguish between assets of the General Fund and the Working Capital Fund; and does not provide data in time to meet financial statement reporting milestones. DoD has not developed interim financial reporting guidance, which has resulted in inconsistent reporting of Government property on DoD financial statements.

**Using CPMS for Financial Statement Reporting.** Despite the problems with CPMS, the Military Departments and Defense agencies must continue using portions of CPMS because it is the only system that reports Government property in the custody of contractors, and it may provide the best data available for some categories of Government property. In IG, DoD, Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997, (see Appendix B) we recommended that the Military Departments identify any systems within their Department that already include Government property in the custody of contractors and determine whether that information is reported for financial statement purposes. The data reported in the CPMS real property and military property categories are generally captured and reported through other DoD systems. Military Departments and Defense agencies should confirm this

## **DoD Issues With Financial Reporting of Government Property in the Custody of Contractors**

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and not use CPMS as a source of financial reporting data for those property categories. See the summaries of the audit reports discussed in Appendix B for examples of duplicate reporting. For the other property categories determined not to be reported through other DoD systems, CPMS has the best data available and should be used for financial reporting until DoD systems can provide better data.

### **Government Property in the Possession of Contractors IPT**

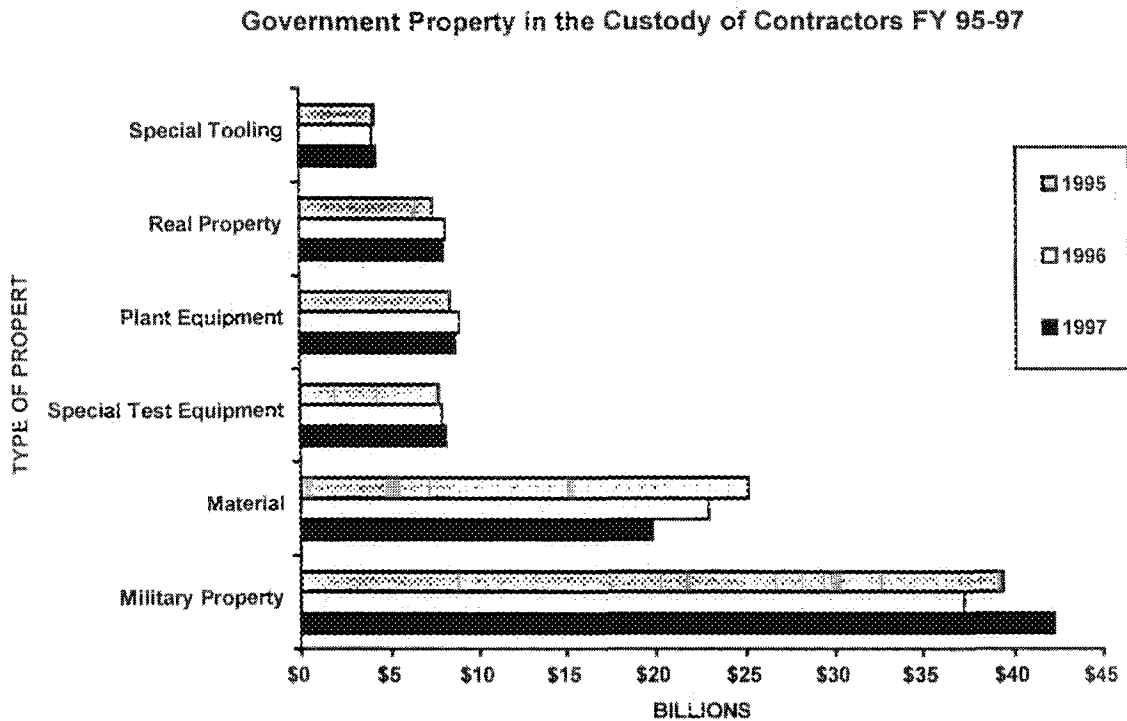
On February 14, 1997, the Under Secretary of Defense for Acquisition and Technology formed the Government Property in the Possession of Contractors Integrated Process Team (IPT) to review problems in the administration of rules governing Government property. The Under Secretary of Defense for Acquisition and Technology; the Under Secretary of Defense (Comptroller); the Military Departments; the Defense Contract Management Command, Defense Logistics Agency; and the audit community were represented on the IPT. One of the areas that the IPT focused on was the physical and financial accountability for Government property.

In June 1997, the IPT presented its conclusions and recommendations to a DoD Executive Review Group. The IPT acknowledged that the CPMS does not provide adequate information for DoD financial statements and did not recommend using the CPMS as a long-term solution to the financial reporting problem. The IPT made recommendations on how the various categories of Government property in the possession of contractors should be reported on the financial statements. However, the IPT did not propose a solution to the overall financial reporting problem--how to get data needed for the financial statements. IG, DoD, Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997, contains a discussion of the IPT conclusions and recommendations on financial reporting of Government property in the possession of contractors.

### **Government Property Reported by Contractors -- FYs 1995 Through 1997**

The amount of Government property in the custody of contractors in FY 1995 was about \$92 billion, in FY 1996, about \$89 billion, and in FY 1997, about \$91 billion. The chart below shows the fluctuations in each property category.

**DoD Issues With Financial Reporting of Government Property in the Custody of Contractors**



**Government Property Reported on FY 1997 Financial Statements.** Since our review of CPMS and the FY 1996 DoD Financial Statements, financial managers in each Military Department have adjusted the way CPMS data are used for financial reporting. In an effort to avoid duplicate reporting, only selected portions of CPMS data were used to report Government property balances in the FY 1997 General Fund financial statements. The results of our DoD-wide audit proved that assets reported in the Land, Other Real Property, and Military Property categories of CPMS were often duplicated in the Military Department general ledger accounts or other systems.

**Army.** For the FY 1997 Army General Fund financial statements, the Army included \$8.1 billion of Government property in the custody of contractors as part of Property, Plant, and Equipment, Net. The \$8.1 billion was obtained from the CPMS by excluding the balances from the Land, Other Real Property, and Military Property categories.

**Navy.** For the FY 1997 Navy General Fund financial statements, the Navy included \$17.6 billion of Government property in the custody of contractors as part of Property, Plant, and Equipment, Net. The \$17.6 billion was obtained from the CPMS by excluding the balances from the Land, Other Real Property, and Military Property categories.

## **DoD Issues With Financial Reporting of Government Property in the Custody of Contractors**

**Air Force.** For the FY 1997 Air Force General Fund financial statements, the Air Force reported \$24.2 billion of Government property in the custody of contractors as part of Property, Plant, and Equipment, Net. Of the \$24.2 billion, \$6.5 billion was obtained from the CPMS by excluding the balances from the Land, Other Real Property, Contractor Acquired Material, Industrial Plant Equipment, and Military Property categories.

**Materiality.** The amount of Government property in the custody of contractors remains material to the DoD financial statements and will prevent DoD from achieving an unqualified opinion if the problems are not corrected. The inability of DoD to resolve the reporting of Government property in the custody of contractors will impede the ability of DoD and the Federal Government to obtain favorable opinions on FY 1999 financial statements.

## **Conclusion**

The results of our DoD-wide audit with the Army Audit Agency, Naval Audit Service, and Air Force Audit Agency, document that a DoD-wide material management control weakness exists for the financial reporting of Government property in the custody of contractors. We commend the Military Departments for their efforts to improve reporting of Government property in the custody of contractors on the financial statements for FY 1997. However, until a DoD standard financial system is implemented that meets the Federal Accounting Standards, DoD will not have accurate, complete, and auditable financial data for approximately \$90 billion of Government property in the custody of contractors. Unless resolved, the financial reporting problems with Government property in the custody of contractors will hamper the ability of DoD and the Federal Government to obtain an unqualified opinion on financial statements.

Although the IPT recommended policy changes to improve controls and reduce the amount of Government property in the hands of contractors, the IPT did not resolve the DoD-wide financial reporting problems. When the IPT reported out to the DoD Executive Review Group, it was agreed that the Office of the Under Secretary of Defense (Comptroller) would lead followon efforts to develop more acceptable approaches to the financial reporting problems.



## **Management Actions by the Office of the Under Secretary of Defense (Comptroller)**

In the first report of this series, Inspector General, DoD, Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997, we recommended that the Under Secretary of Defense (Comptroller) form a working group to develop solutions to the financial management issues (see Appendix B for details). No response was received, but it was assumed that action would be taken in accordance with the commitment to the Executive Review Group. After we realized that action was not under way, on April 23, 1998, we sent a memorandum (a copy of the memorandum is included in this report at Appendix C) to the Deputy Chief Financial Officer again requesting comments. On July 31, 1998, the Office of the Under Secretary of Defense (Comptroller) provided comments in response to the April 23, 1998, memorandum. See Part III for the complete text of management comments. A discussion of management comments is provided below.

**Management Comments to Recommendation A.1. of Inspector General, DoD, Report No. 97-202.** Recommendation A.1. recommended forming a working group to develop short-term and long-term solutions to the financial accountability and reporting problems regarding Government property in the possession of contractors. The Principal Deputy Under Secretary of Defense (Comptroller) nonconcurred with the recommendation. She stated that forming a working group is contrary to the Defense Reform Initiative that mandates reducing the number of committees, which includes working groups. As an alternative, we noted that in a June 5, 1998, memorandum from the Office of Management and Budget, the Secretary of Defense was directed to submit a plan for resolving material management deficiencies identified by the General Accounting Office and the DoD Inspector General. One of the implementation approaches to correct material deficiencies concerns Government property in the possession of contractors. The implementation approaches were to be submitted to the Office of Management and Budget by July 31, 1998. The implication was that a working group was not necessary to develop a strategy for addressing this issue.

**Audit Response.** We disagree that forming a working group is contrary to the direction of the Defense Reform Initiative. There is a compelling need for joint efforts to find solutions to the DoD financial issues and several such efforts are currently under way. We are willing to accept the DoD Proposed Implementation Strategy as a means for moving this issue forward.

## **DoD Issues With Financial Reporting of Government Property in the Custody of Contractors**

**Management Comments to Recommendation A.2. of Inspector General, DoD, Report No. 97-202.** Recommendation A.2. recommended reporting the financial reporting of Government property as a DoD material weakness in the FY 1998 DoD Annual Statement of Assurance. The Principal Deputy Under Secretary of Defense (Comptroller) partially concurred with the recommendation. She stated the material weakness was identified in the Department's FY 1997 Annual Statement of Assurance and therefore should not be reported as a new DoD material weakness.

**Audit Response.** The Principal Deputy Under Secretary of Defense (Comptroller) comments are responsive to the intent of the recommendation, which was to continue reporting this weakness.

### **Additional Management Actions**

We commend the Navy, Air Force, and the Defense Logistics Agency for taking action on recommendations made in IG, DoD, Report No. 97-202. The Navy and Air Force have initiated reviews of their systems to determine where Government property data are being captured and reported. The Defense Logistics Agency redesign of the Contract Property Management System, scheduled to be completed in FY 1998, will improve the timeliness and quality of its property data.

## **Part II - Additional Information**

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# Appendix A. Audit Process

## Scope and Methodology

Auditors from the IG, DoD; Army Audit Agency; Naval Audit Service; and the Air Force Audit Agency performed this DoD-wide audit. We reviewed the use of CPMS for the financial reporting of Government property in the custody of contractors (IG, DoD, Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997). In addition, we reviewed the FY 1996 financial reporting of Government property in the custody of contractors at the following Defense agencies (IG, DoD, Report No. 98-042, "Financial Reporting by Selected Defense Agencies of Government Property in the Custody of Contractors," December 16, 1997).

- o American Forces Information Service
- o Defense Information Systems Agency
- o Defense Special Weapons Agency

The Military Department audit agencies reviewed the FY 1996 financial reporting of Government property in the custody of contractors within their individual Military Departments and issued separate reports. See Appendix B for summaries of the reports issued on this DoD-wide project.

In addition to the audit results of our FY 1996 effort, this summary report includes updated information on the amount of Government property in the custody of contractors over the last 3 years and on the reporting of approximately \$91 billion of Government property in the FY 1997 General Fund financial statements.

**DoD-wide Corporate Level Government Performance and Results Act (GPRA) Goals.** In response to the GPRA, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

**Objective:** Fundamentally reengineer the Department and achieve a 21<sup>st</sup> century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

**DoD Functional Area Reform Goals.** Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

**Financial Management Area. Objective:** Reengineer DoD business practices. **Goal:** Standardize, reduce, clarify, and reissue financial management policies. (FM-4.1)

**Financial Management Area. Objective:** Reengineer DoD business practices. **Goal:** Improve data standardization of finance and accounting data items. (FM-4.4)

**General Accounting Office High Risk Area.** The General Accounting Office (GAO) has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

**Audit Type, Dates, and Standards.** We performed this financial-related audit during the period April 1996 through March 1998. This audit was made in accordance with auditing standards that the Comptroller General of the United States issued as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

**Contacts During the Audit.** We visited or contacted individuals and organizations within the DoD. We also visited DoD contractors. Further details are available on request.

## Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

**Scope of Review of the Management Control Program.** We reviewed the management control program at the Defense Contract Management Command and the American Forces Information Service, the Defense Information Systems Agency, and the Defense Special Weapons Agency. The Military Department audit agencies reviewed the management control programs applicable to their respective Military Departments.

## **Appendix A. Audit Process**

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**Adequacy of Management Controls.** The results of the DoD-wide audit efforts by the IG, DoD; Army; Navy; and Air Force audit organizations indicate that a DoD-wide material management control weakness exists for financial reporting of Government property in the custody of contractors, as defined by DoD Directive 5010.38. This was reported as a new material management control weakness in FY 1997. It will continue to be reported as a material weakness in FY 1998. Recommendation A.1. in the IG, DoD, Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997, if implemented, will assist DoD in correcting the material weakness. A copy of that report was provided to the senior official responsible for management controls in the Office of the Under Secretary of Defense (Comptroller) and this report will be handled similarly.

### **Summary of Prior Coverage**

General Accounting Office Report No. AIMD-96-7 (OSD Case No. 1050), "Chief Financial Officers Act Financial Audits: Increased Attention Must Be Given to Preparing Navy's Financial Reports," March 27, 1996

General Accounting Office Report No. AIMD-94-136 (OSD Case No. 9804), "Office of Management and Budget's High-Risk Program: Comments on the Status Reported in the President's FY 1995 Budget," September 20, 1994

Inspector General, DoD, Report No. 97-129, "Financial Accounting at the On Site Inspection Agency," April 15, 1997

Inspector General, DoD, Report No. 96-212, "Capitalization of DoD General Property, Plant, and Equipment," August 19, 1996

Inspector General, DoD, Report No. 96-155, "The Defense Information Systems Agency [DISA] General Ledger Military Equipment Account," June 10, 1996

Inspector General, DoD, Report No. 96-039, "Financial Accounting for the Defense Nuclear Agency," December 11, 1995

Inspector General, DoD, Report No. 95-301, "Major Deficiencies Preventing Auditors From Rendering Audit Opinions on DoD General Fund Financial Statements," August 29, 1995

Inspector General, DoD, Report No. 94-073, "Defense Finance and Accounting Service Work on the Air Force FY 1992 Financial Statements," March 31, 1994

Inspector General, DoD, Report No. 93-037, "Government Property in the Custody of Contractors," December 17, 1992

Army Audit Agency Report No. HQ 94-452, "Audit of the Army's FY 93 Financial Statements, Follow-up Issues," August 30, 1994

Army Audit Agency Report No. CR 94-204, "Government-furnished Property," March 31, 1994

Army Audit Agency Report No. CR 93-216, "Financial Accounting for Government-furnished Property," June 28, 1993

Air Force Audit Agency Project 96053011, "Review of Government-furnished Property, FY 1995 Air Force Consolidated Financial Statements," October 22, 1996

Air Force Audit Agency Project 95053002, "Review of Property, Plant, and Equipment, FY 1995 Air Force Consolidated Financial Statements," June 13, 1996

Air Force Audit Agency Project 94064003, "Government Property in the Possession of Service Contractors," August 7, 1995

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## **Appendix B. Summary of Reports from DoD-wide Audit**

As a result of the DoD-wide audit effort, the Inspector General, DoD; the Army Audit Agency; the Naval Audit Service; and the Air Force Audit Agency issued several reports.

### **Inspector General, DoD, Reports**

**Report No. 98-042, "Financial Reporting by Selected Defense Agencies of Government Property in the Custody of Contractors," December 16, 1997,** addresses the reporting of Government property in the custody of contractors on the financial statements of the Defense Information Systems Agency, Defense Special Weapons Agency, and American Forces Information Service. The report states that the three Defense agencies did not report Government property in the FY 1996 financial statements. As a result, the FY 1996 property balances in these Defense agency financial statements were misstated by at least \$171 million. The report recommended that the three Defense agencies provide a point of contact to the Under Secretary of Defense (Comptroller) for the financial reporting issues working group recommended in IG, DoD, Report No. 97-202, and identify systems that include Government property in the custody of contractors. The three Defense agencies concurred with the recommendations.

**Report No. 97-202, "Financial Reporting of Government Property in the Custody of Contractors," August 4, 1997,** addresses the use of CPMS for the financial reporting of Government property. The report states that CPMS does not meet DoD requirements for financial statement reporting. Therefore, the system cannot be relied on for reporting the value of Government property balances in the financial statements. In addition, CPMS does not completely or accurately report Government property. As a result, errors totaling \$962 million were found in CPMS, and DoD has no assurance that the remainder of the data were complete and accurate. The report recommended that the Under Secretary of Defense (Comptroller) establish a working group to develop solutions regarding the financial accountability and reporting problems of Government property and develop policy for financial reporting. The Under Secretary of Defense (Comptroller) did not comment on the report. The report also recommended that the Commander, Defense Contract Management Command, Defense Logistics Agency, complete the redesign of CPMS and require property administrators to



use the Defense Contract Management Command Property Administration Data System to identify contracts with Government property. The Defense Contract Management Command concurred with the recommendation and CPMS is currently in the redesign process.

## **Army Audit Agency Report**

**Report No. AA 97-148, "Army's Principal Financial Statements for Fiscal Years 1996 and 1995, Financial Reporting of Government-furnished Property," September 30, 1997,** states that amounts contractors reported as Government property in their possession weren't accurate enough for financial reporting. Also, the related accounting procedures were flawed and compounded the data accuracy problems. As a result, the fixed asset lines in the Army FY 1996 General Fund statements which incorporate the value of property furnished to contractors--an aggregate reported amount of \$14.1 billion--were materially misstated and unauditible. The report recommended that the Director, Defense Finance and Accounting Service and the Assistant Secretary of the Army (Financial Management and Comptroller): exclude contractor-reported amounts for military property from the year-end Government-furnished property adjustment; establish a separate general ledger account within the Commodity Command Standard System for repair-and-return inventory items; and direct the accounting offices that support commodity commands to stop manually recording the value of military property, and Government material and equipment reported by contractors in the Standard Operations and Maintenance Research and Development System. The Director, Defense Finance and Accounting Service and the Assistant Secretary of the Army (Financial Management and Comptroller) generally concurred with the recommendations. Copies of this report can be requested by calling (703) 681-9883.

## **Naval Audit Service Report**

**Report No. 046-97, "Department of the Navy Fiscal Year 1996 Annual Financial Report: Government Property Held by Contractors," August 14, 1997,** states that the \$32.7 billion of Government property held by contractors reported on the FY 1996 Department of the Navy Statement of Financial Position was not supported by accurate accounting data. Records were incomplete, included inappropriate data, and contained about \$2.1 billion in duplicate reporting. Without adequate accounting systems, the Department of the Navy did

## **Appendix B. Summary Reports from DoD-wide Audit**

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not know the actual dollar value of Government property provided to or acquired by contractors. The report recommended that the Assistant Secretary of the Navy (Financial Management and Comptroller):

- o request DoD interim guidance on how to improve the accuracy and completeness of reporting Government property held by contractors;

- o determine the amount of aircraft reported to CPMS, and reduce the FY 1997 Department of Navy Statement of Financial Position inputs for Property, Plant, and Equipment, Net, by that amount; and

- o reduce the prior year balance of Property, Plant, and Equipment, Net, by \$2,054,651,000 for FY 1997 reporting purposes, to reflect duplicate reporting of aircraft in FY 1996.

Naval Audit Service stated that the Assistant Secretary of the Navy (Financial Management and Comptroller) planned to take sufficient action for all three recommendations. Copies of this report can be requested at (703) 681-9126.

## **Air Force Audit Agency Report**

**Project 96053017, "Government-furnished Property, Fiscal Year 1996 Air Force Consolidated Financial Statements," August 4, 1997**, states that the Government-furnished property balance reported in the FY 1996 financial statements was not accurate. A \$21.4 billion unreconciled difference existed between financial statement and contractor-reported Government-furnished property values. The inaccuracy of the reported balances directly affected the auditors' ability to determine whether the Air Force financial statements, taken as a whole, fairly presented the Air Force financial position as of September 30, 1996. The report made no recommendations, deferring to the Inspector General, DoD, to make DoD-wide recommendations. Copies of this report can be requested by contacting the Assistant Auditor General, Operations, at (703) 696-8026 (DSN 426-8026) or e-mail to [reports@af.pentagon.mil](mailto:reports@af.pentagon.mil).

## Appendix C. Memorandum to the Deputy Chief Financial Officer



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

APR 23 1998

MEMORANDUM FOR DEPUTY CHIEF FINANCIAL OFFICER, OFFICE OF THE  
UNDER SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Management Comments on Inspector General, DoD, Report No 97-202,  
"Financial Reporting of Government Property in the Custody of  
Contractors," August 4, 1997

We have not received a response from your office to the subject report, issued in August 1997. We are interested in your response because of the seriousness of the issues discussed in the report. The issues directly affect the DoD financial statements and could prevent favorable opinions on most DoD financial statements, as well as the consolidated financial statements of the Federal Government. Although the joint Integrated Process Team, initiated by the Office of the Under Secretary of Defense for Acquisition and Technology, was to address operational and financial issues with Government property in the custody of contractors, the financial management issues remain. We believe that only your office can lead the effort to develop long-term solutions to these issues.

Please provide your response to our audit report by May 27, 1998. Include in your response any actions taken since our report was issued in August 1997, planned actions, and milestones. We will consider your response to this memorandum a response to the audit report. Our draft summary audit report, to be issued in the next few weeks, will state that we sent you this memorandum requesting comments. Comments we receive in response to this memorandum will be considered in preparing our final summary report.

Questions on the audit should be directed to Mr. Richard B. Bird, Audit Program Director, at (703) 604-9175 (DSN 664-9175) or e-mail [rbird@DODIG.OSD.MIL](mailto:rbird@DODIG.OSD.MIL). Questions may also be directed to Ms. Linda A. Pierce, Audit Project Manager, at (216) 522-6091 (DSN 580-6091), extension 234, or e-mail [lap@DODIG.OSD.MIL](mailto:lap@DODIG.OSD.MIL).

A handwritten signature in cursive script that reads "Robert J. Lieberman".

Robert J. Lieberman  
Assistant Inspector General  
for Auditing

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## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition and Technology  
Deputy Under Secretary of Defense (Acquisition Reform)  
Deputy Under Secretary of Defense (Industrial Affairs & Installations)  
Director, Defense Procurement  
Director, Defense Logistics Studies Information Exchange  
Under Secretary of Defense (Comptroller)  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Assistant Secretary of Defense (Public Affairs)

### **Department of the Army**

Secretary of the Army  
Assistant Secretary of the Army (Financial Management and Comptroller)  
Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Financial Management and Comptroller)  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force

### **Other Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Finance and Accounting Service  
Director, Defense Information Systems Agency

## **Other Defense Organizations (continued)**

Director, Defense Logistics Agency  
    Commander, Defense Contract Management Command  
Director, Defense Special Weapons Agency  
Director, National Security Agency  
    Inspector General, National Security Agency  
Director, On Site Inspection Agency  
Inspector General, Defense Intelligence Agency  
Director, American Forces Information Service

## **Non-Defense Federal Organizations and Individuals**

Office of Management and Budget  
Technical Information Center, National Security and International Affairs Division,  
    General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on National Security, Committee on Appropriations  
House Committee on Government Reform and Oversight  
House Subcommittee on Government Management, Information, and Technology,  
    Committee on Government Reform and Oversight  
House Subcommittee on National Security, International Affairs, and Criminal Justice,  
    Committee on Government Reform and Oversight  
House Committee on National Security



## **Part III - Management Comments**

# Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

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

JUL 31 1998



MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE,  
OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF  
DEFENSE

SUBJECT: Audit Report 97-202, "Financial Reporting of Government Property in the Custody  
of Contractors," dated August 4, 1997

This is in response to your request for comments on the subject audit report. This office  
nonconcurrs on the first recommendation and partially concurs on the second recommendation  
contained in the report. Attached are this office's specific comments on the audit report.

The staff point of contact on this action is Mr. Stephen Tabone. He may be reached by  
e-mail: [tabones@ousdc.osd.mil](mailto:tabones@ousdc.osd.mil) or by telephone at (703) 693-6520.

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

Attachment



## Under Secretary of Defense (Comptroller) Comments

**OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)  
COMMENTS ON OIG AUDIT REPORT 97-202, DATED AUGUST 4, 1997  
"FINANCIAL REPORTING OF GOVERNMENT PROPERTY  
IN THE CUSTODY OF CONTRACTORS"  
(PROJECT NO. 6FI-2009.01)**

Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) comments are provided below on Finding A, Recommendations A.1 and A.2. No comments are provided on Recommendation A.3 or Finding B, since the recommendations were not addressed to the OUSD(C).

**OIG Recommendation A.1:** We recommend that the Under Secretary of Defense (Comptroller) (USD(C)) form a working group to review the conclusions of the Government Property in the Possession of Contractors Integrated Process Team in the financial area, and develop short-term and long-term solutions to the financial accountability and reporting problems regarding Government property in the possession of contractors. The USD(C) should require participation in the working group by the acquisition and logistics community, the Military Department financial organizations, the Inspector General, Department of Defense (DoD), the Defense Finance and Accounting Service, the Defense Contract Management Command (DCMC), and any Defense Agencies with Government property in the possession of contractors. (The OIG recommendation further identifies seven goals of the working group.)

**OUSD(C) Response:** Nonconcur. Forming a working group is contrary to the direction contained in the Secretary of Defense's Defense Reform Initiative (DRI) that mandates reducing the number of committees, which includes working groups. Therefore, the Office of the Under Secretary of Defense (Acquisition and Technology) (OUSD(A&T)) and the OUSD(C) do not agree with the recommendation to form a working group. However, we do agree that the area of government property in the possession of contractors has been, and continues to be, a management concern that requires the Department's attention. In this regard, the OUSD(A&T) and the OUSD(C), jointly, will continue to actively work this issue.

As you know, the first ever Consolidated Financial Statement for the U.S. Government was issued earlier this year. The General Accounting Office audited those statements and rendered a "disclaimer" (unfavorable) audit opinion. In response, the Administration established a goal to achieve an "unqualified" (clean) audit opinion on the Government's financial statements for FY 1999. The Secretary of Defense, in his memorandum of May 15, 1998 (copy attached), has committed senior management within the Department to supporting this goal.

Over the last several months, both the OUSD(A&T), the OUSD(C) and other offices have developed implementation approaches for the material deficiencies identified by the Office of Management and Budget (OMB) in its letter to the Secretary, dated June 5, 1998 (copy also attached). Since government property in the hands of contractors is estimated to be valued at over \$90 billion, it materially affects the financial statements of the DoD. Thus, government property in the hands of contractors has been separately identified by the Department as an area

Attachment

## Under Secretary of Defense (Comptroller) Comments

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that, potentially, could prevent the Government from achieving an unqualified audit opinion for FY 1999. In this regard, one of the implementation approaches to be submitted to the OMB on July 31, 1998, for its approval, concerns this issue. This office will provide your office a copy of the submission to the OMB, when it is finalized.

**OIG Recommendation A.2:** We recommend that the USD(C) report the financial reporting of Government property as a DoD material weakness in the FY 1998 DoD Annual Statement of Assurance.

**OUSD(C) Response:** Partially concur. The DoD recognizes that the Contract Property Management System (CPMS), as well as other property accountability systems, were not designed to support financial statements and, therefore, do not provide accurate or timely financial data regarding government property in the hands of contractors. Specifically, the CPMS does not apply capitalization thresholds, does not provide timely information and does not distinguish between the assets of the general fund and the Working Capital Fund. Additionally, as stated in the audit, the system does not compute depreciation and, duplicates assets otherwise reported in general ledger accounts. Integration of property accountability systems and financial accounting and reporting systems continues to be a priority within the Department. This deficiency, as well as milestones for corrective action, previously have been identified in the Department's FY 1997 Annual Statement of Assurance. Therefore, the Department does not believe that it is necessary to report this as a new DoD material weakness.

Attachment

## Under Secretary of Defense (Comptroller) Comments



THE SECRETARY OF DEFENSE  
WASHINGTON, DC 20301-1000

MAY 15 1996

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS  
CHAIRMAN OF THE JOINT CHIEFS OF STAFF  
UNDER SECRETARIES OF DEFENSE  
DIRECTOR, DEFENSE RESEARCH AND ENGINEERING  
ASSISTANT SECRETARIES OF DEFENSE  
GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE  
INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE  
DIRECTOR, OPERATIONAL TEST AND EVALUATION  
ASSISTANTS TO THE SECRETARY OF DEFENSE  
DIRECTOR, ADMINISTRATION AND MANAGEMENT  
DIRECTORS OF THE DEFENSE AGENCIES  
DIRECTORS OF THE DOD FIELD ACTIVITIES

SUBJECT: Department of Defense Financial Business Practices Reform

The Department as a whole, and functional managers in particular, need better financial information to conduct their far-flung operations. For example, the Department's managers need to be able to answer questions about: (1) the amounts owed to, or owed by, the Department, (2) amounts estimated to be required for future environmental cleanup efforts, (3) the cost of overhead or other infrastructure, as well as (4) other questions regarding the actual costs of specific activities after they have been performed. Unfortunately, this information often is hard to develop.

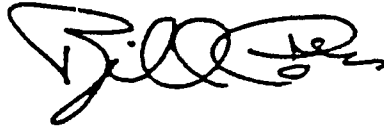
One reason for this difficulty is that our acquisition, logistical, medical, personnel, and other processes and systems, designed to fulfill important management functions, do not do a good job of capturing and reporting financial data to the Chief Financial Officer community. One consequence is that the Department's financial statements, a score card of how well the Department executes its fiduciary responsibilities, have not received a favorable audit opinion over the last several years. This is unacceptable.

Another reason is that the Department historically has managed by a "stove pipe" budget execution process. Military Departments develop weapons systems using research, development, test and evaluation funds; acquire weapons system with procurement funds; maintain weapons system with operation and maintenance (O&M) dollars; and operate weapons system utilizing O&M and military personnel funds. Since these costs are funded by different appropriations, often without any linkage between the appropriations, program managers must manually calculate or estimate actual costs using information from multiple systems. While the Department has done a credible job of estimating its resource needs and requirements, and in executing and accounting for its budget authority, it does not do well in meeting current requirements to account for and report the total cost of its varied missions that span multiple appropriations.

## Under Secretary of Defense (Comptroller) Comments

This is a Department-wide management problem, not just a financial management problem. For this reason, initiatives to improve the accuracy, timeliness and usefulness of financial information must be developed through the Defense Management Council. I have instructed the Under Secretary of Defense (Comptroller) to oversee the Department's efforts to improve the manner in which financial information is captured and reported in all of the Department's systems--not just its financial systems. Further, I am directing that you provide the Under Secretary of Defense (Comptroller) your support to achieve one of the Administration's top priorities--a favorable audit opinion on financial statements.

To achieve more favorable opinions, a number of steps must be undertaken immediately. In particular, the acquisition, logistical, medical, and personnel processes and systems must be modified to encompass new functionalities and retrofitted to adequately capture and report necessary information. Only by achieving favorable audit opinions on our financial statements can the Department restore its credibility with the public and ensure that we, as senior managers, are effectively carrying out our fiduciary responsibilities.



**Under Secretary of Defense (Comptroller) Comments**



DEPUTY DIRECTOR  
FOR MANAGEMENT

EXECUTIVE OFFICE OF THE PRESIDENT  
OFFICE OF MANAGEMENT AND BUDGET  
WASHINGTON, D. C. 20503

OFFICE OF THE  
DEPUTY DIRECTOR  
FOR MANAGEMENT  
JUN 11 11 28 AM '98

June 5, 1998

The Honorable William S. Cohen  
Secretary of Defense  
Washington, DC 20301-1000

Dear Mr. Secretary:

The Office of Management and Budget (OMB) has identified the Department of Defense (DOD) as an agency subject to reporting under the enclosed memorandum from the President dated May 26, 1998, Subject: Actions to Further Improve Financial Management. In the memorandum, the President directs the head of each agency identified by OMB to submit a plan for resolving material management deficiencies identified by the agency's auditors.

For your agency, the General Accounting Office and the DOD Inspector General identified material deficiencies in: valuing and reporting property, equipment, inventory and supplies; estimating and reporting liabilities related to the disposal of hazardous waste and remediation of environmental contamination; identifying and reporting financial transactions within the agency and between DOD component organizations and other Federal entities; reconciling cash balances between DOD and the Treasury; and estimating and reporting liabilities for post-retirement health benefits for military employees. DOD's plan should focus on your priorities for addressing these deficiencies and specific steps that the agency will take to correct them. The plan should provide the following information for each material deficiency noted above:

- What steps will be taken to correct the deficiency
- When will each step be completed
- What senior agency officials will be responsible for resolving each deficiency
- How will the agency measure its progress

Please submit DOD's plan by July 31, 1998, to:

Acting Deputy Director for Management  
Office of Management and Budget  
260 Old Executive Office Building  
Washington, DC 20503

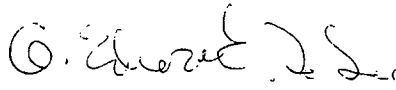
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**Under Secretary of Defense (Comptroller) Comments**

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Financial and management issues at DOD, taken together, represent the single largest challenge that we must effectively address to achieve the Administration's goal of an unqualified audit opinion on the consolidated financial statements of the U S Government for fiscal year 1999 We look forward to working with you to reach this goal

Sincerely,



G Edward DeSeve  
Acting Deputy Director  
for Management

Enclosure

## **Audit Team Members**

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, produced this report.

F. Jay Lane  
Salvatore D. Guli  
Brian M. Flynn  
Richard Bird  
Linda A. Pierce  
Mark A. Krulikowski

