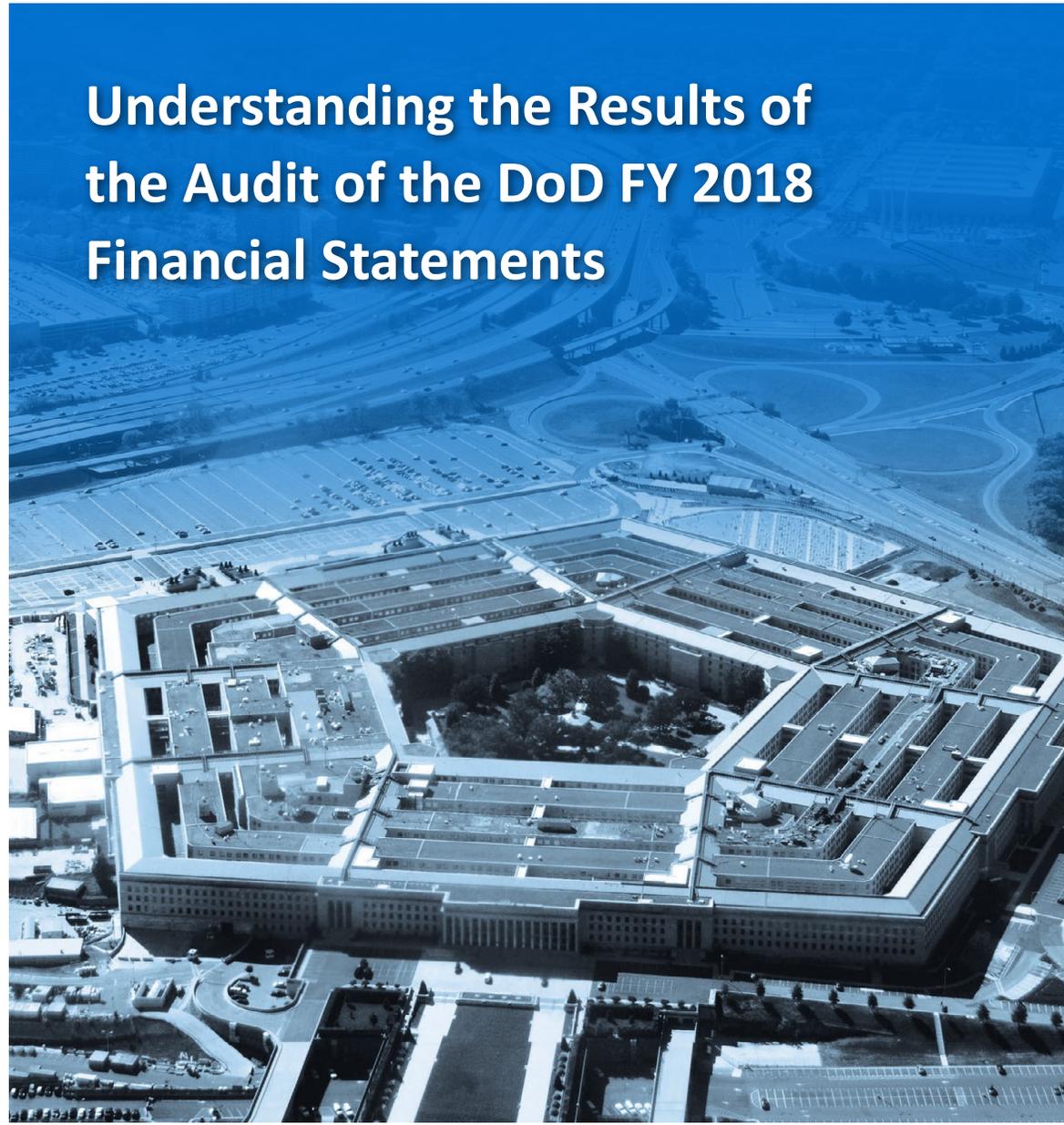




# INSPECTOR GENERAL

*U.S. Department of Defense*

JANUARY 8, 2019



## Understanding the Results of the Audit of the DoD FY 2018 Financial Statements

INTEGRITY ★ INDEPENDENCE ★ EXCELLENCE





**INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
4800 MARK CENTER DRIVE  
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January 8, 2019

The Department of Defense Office of Inspector General (DoD OIG) conducted and oversaw the first full audit of the DoD's financial statements in Fiscal Year (FY) 2018.

This audit effort, required by the Chief Financial Officers Act of 1990 (CFO Act of 1990) and National Defense Authorization Act of 2014, was a massive and expensive undertaking. Over 1,000 auditors from the DoD OIG and from five independent public accounting firms overseen by the DoD OIG performed audits of many DoD Components' financial statements as well as the consolidated DoD Agency-Wide Basic Financial Statements. According to the DoD Chief Financial Officer (CFO), this was one of the largest financial statement audits in history.

On November 15, 2018, the DoD OIG issued a disclaimer of opinion on the DoD financial statements. This is the first year that the DoD has undergone a full financial statement audit, and the DoD did not expect to obtain a clean opinion. In fact, the DoD stated in its assertion of audit readiness for FY 2018 that that it was not certifying that the Agency-Wide or DoD Component financial statements were reliable.

Therefore, the most important outcome this year was not the overall opinion, but that the audit identified specific deficiencies in DoD financial management and reporting processes, and that the DoD makes progress in fixing those deficiencies.

The opinions issued by the auditors contain technical language and follow a format dictated by auditing standards. However, we believe it is important for non-auditors to understand the background and importance of these audits; how the audits were conducted; what the audits found; how the audit can help the DoD more effectively manage its resources and operations; and what the DoD is doing, and needs to do, to make progress on its financial reporting.

That is the purpose of this report—to summarize in terms understandable to non-auditors the purpose, findings, and potential benefits of the DoD's financial statement audits.

As described in this report, the audits identified many deficiencies in DoD financial management and reporting—20 overall material weaknesses and more than 2,400 notices of findings and recommendations, including weak information technology controls, insufficient controls to ensure the accuracy and completeness of property, and incomplete universes of financial transactions. It is critical for the DoD to implement corrective action plans and to monitor the implementation of those corrective actions.

To be clear, obtaining a clean audit opinion is important to the DoD and necessary for the government-wide financial statements to receive a clean opinion. However, the financial statement audit has value beyond the audit opinion. The audit and more accurate financial statements can enable Congress and the public to receive a more accurate assessment of how the DoD spends its money; help the DoD fix vulnerabilities in information technology systems; prevent wasteful practices; and assist the DoD to improve operational decisions.

The road to a clean opinion is not short; it will not happen immediately. Continued progress requires sustained effort and attention throughout the Department. DoD leadership has stressed the impact of the financial statement audits, as well as the need to develop efficient and effective business processes that can lead to accurate financial information and improve DoD operations. From the Secretary of Defense, the Deputy Secretary of Defense, and the DoD CFO on down, DoD leaders have emphasized the importance of the audit, the need to cooperate with our auditors, and the need to fix identified deficiencies.

At the DoD OIG, we will continue to fully and fairly audit the financial statements, identify deficiencies, and provide clear information to the DoD on what is necessary to fix these deficiencies. This is an important, long-term effort that we are committed to supporting. We hope this report helps in that effort.

A handwritten signature in black ink that reads "Glenn A. Fine". The signature is written in a cursive, flowing style.

Glenn A. Fine  
Principal Deputy Inspector General  
Performing the Duties of the Inspector General

# Understanding the Results of the FY 2018 Audit of the Department of Defense's Financial Statements

The Department of Defense (DoD) prepares the annual Agency Financial Report (financial report) to describe and communicate the financial position and results of operations of the DoD. In previous years, the DoD's financial report was not fully audited because the National Defense Authorization Act of 2002 required the DoD Office of the Inspector General (OIG) to only perform the procedures necessary to audit what the DoD asserted as audit ready. The DoD did not assert to audit readiness for its financial statements until FY 2018.

To comply with the National Defense Authorization Act of 2014, the DoD OIG ensured that the DoD's financial statements underwent a full audit in FY 2018. The DoD OIG, and five independent public accounting firms overseen by the DoD OIG, performed 21 audits consisting of audit procedures on balances listed on the DoD's and DoD Components' financial statements to determine if the financial statements were accurately presented.<sup>1</sup> In addition, the DoD OIG audited the consolidated DoD Agency-Wide Basic Financial Statements, which is the combination of the DoD Components' financial statements.

These audits resulted in audit opinions, which determined whether the financial statements were fairly presented in accordance with Generally Accepted Accounting Principles. In addition, the auditors provided a report to the audited entity that identified the material weaknesses, significant deficiencies, and instances of non-compliance with laws and regulations within the DoD and the DoD Components.

Audit opinions, by their nature and by the requirements of generally accepted auditing standards, are technical, follow a prescribed format, and may not be easy to understand without a background in accounting. The objective of this report is to explain the financial report and the financial statement audits in a way that is understandable and meaningful to a non-auditor.

This report describes the importance of financial statement audits and the roles and responsibilities of DoD management and the auditors that reviewed the financial statements. It also summarizes the FY 2018 DoD Component and Agency-Wide audit results, discusses significant material weaknesses, and provides the DoD OIG's perspective on what the DoD should do to progress towards clean opinions and stronger financial management.

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<sup>1</sup> The DoD OIG contracted with six independent public accounting firms to support the overall audit of the DoD. Five independent public accounting firms performed full financial statement audits of one or more DoD Components and one independent accounting firm performed limited internal control testing over entity controls for DoD Components.

## A. Agency Financial Report

The goal of an agency's financial report is to provide a comprehensive and accurate overview of the agency's finances, mission, and other general information. In addition to the financial statements and related notes, a financial report includes insights into the agency's operations, the agency's assessment of its own internal controls, the agency's compliance with laws and regulations, and material weakness in the processes the agency follows to complete its financial statement reporting.

### 1. Sections of the DoD Agency Financial Report

The DoD Agency Financial Report for FY 2018 contains eight major sections.

- **Management's Discussion and Analysis.** This section of the Financial Report provides a high-level overview of the DoD's operations and financial performance. This section also includes a summary of the DoD's mission and structure and the current state of financial management systems. In addition, this section includes a discussion regarding the DoD's compliance with certain laws and regulations, such as the Antideficiency Act and the Digital Accountability and Transparency Act of 2014, and the DoD's Statement of Assurance, which summarizes its compliance with the Federal Managers' Financial Integrity Act of 1982 and the Federal Financial Management Improvement Act of 1996. The Statement of Assurance discusses improvements to the DoD's internal controls that resulted in cost savings and increases in efficiency and effectiveness.
- **Financial Statements.** This section of the Financial Report provides consolidated financial information, for all DoD entities, on the DoD's financial operations, condition, and position. The DoD Financial Statements include four principle statements.
  - *Consolidated Balance Sheet.* The balance sheet documents the value of assets and liabilities that the DoD has on a specific date. Assets are owned or managed by the DoD and include cash, investments, property, and inventory. Liabilities are amounts owed by the DoD to others, such as accounts payable and unpaid benefits to military and other Federal employees. The net position is the difference between the assets and liabilities.
  - *Consolidated Statement of Net Cost.* This statement identifies how much it costs, by specific program, to operate the DoD. The DoD reports on seven programs: Military Retirement Benefits; Civil Works; Military Personnel; Operations, Readiness and Support; Procurement; Research, Development, Test and Evaluation; and Family Housing and Military Construction. The DoD's net cost is the difference between costs, revenue, and any gains or losses recognized from changes in investments. Each of the programs has different types of revenue, such as amounts received from local or state governments for research and development.

- *Consolidated Statement of Changes in Net Position.* This statement provides information concerning the money the DoD receives through appropriations from Congress and, after deducting net cost, the DoD’s “bottom line” net operating revenue or cost. In addition, it presents the appropriations provided to the DoD that remain unused at the end of the fiscal year. In addition, the statement focuses on how the DoD’s operations are financed. The change in net position equals the difference between assets and liabilities.
- *Combined Statement of Budgetary Resources.* This statement provides information about how the DoD received its budgetary resources. For example, the DoD could receive budgetary resources through appropriations made by Congress or the DoD could have unspent funds from the prior year. The statement also provides the status of the DoD’s budgetary resources at the end of the fiscal period. For example, if the DoD does not spend its funds within the legal timeframes, the funds expire. In FY 2018, the DoD reported \$27.7 billion of expired funds, meaning that, generally, the DoD can no longer use those funds for new spending.
- **Notes to the Financial Statements.** This section provides important disclosures and details related to the information reported on the DoD’s consolidated financial statements. For example, one of the required notes provides information regarding legal claims against the DoD. The note discusses the number of cases and total dollar value by the level of probability that the DoD will actually incur a liability.
- **Required Supplementary Stewardship Information.** This section highlights substantial DoD investments that have long-term benefits to the public, including programs related to nonfederal physical property, such as property owned by state and local governments, and research and development. For example, investments in research and development may include the development and testing of prototypes for weapon systems.
- **Required Supplementary Information.** This section provides information on other supplementary topics to enhance understanding of the DoD’s financial operations, condition, and position. For example, this information provides a detailed presentation of maintenance and repairs that were not performed when needed or were scheduled to be performed and were delayed, which provides information on the DoD’s ability to keep real property assets in an acceptable condition.
- **DoD OIG Audit Report.** This report, written by the DoD OIG, presents the results of the DoD OIG’s audit of the DoD Agency-Wide Basic Financial Statements and notes to the financial statements. The report includes the DoD OIG’s overall audit opinion on the basic financial statements. In addition to the opinion, the report contains a report on the DoD’s internal control over financial reporting, including a discussion of material weaknesses in the DoD’s business processes that could result in a material misstatement in the financial statements, and a report on the DoD’s compliance with applicable laws and regulations.

- **Other Information.** This section provides the DoD’s summary of the financial statement audit, including a list of self-reported material weaknesses and planned corrective actions that the DoD has implemented or plans to implement to address its material weaknesses. Material weaknesses are deficiencies or a combination of deficiencies in internal control over financial reporting that result in a reasonable possibility that management will not prevent, or detect and correct, a material misstatement in its financial statements in a timely manner.
- **Summary of the DoD Inspector General, “Fiscal Year 2019 Top Management Challenges.”** This section is a statement of what the DoD Inspector General considers the most serious management and performance challenges facing the DoD. According to the Reports Consolidation Act of 2000, this annual statement is prepared by the Inspector General and must be included in the DoD financial report.

## **2. Consolidated Financial Statements**

The DoD’s FY 2018 financial report presents the consolidated financial information for 63 DoD entities. The DoD OIG audited or oversaw the audits of 21 DoD Component financial statement audits as well as the audit of the FY 2018 DoD Agency-Wide Basic Financial Statements.<sup>2</sup>

In addition, independent public accounting firms performed audits of seven DoD Components, including the Defense Finance and Accounting Service (DFAS), the Defense Contract Audit Agency, the Defense Commissary Agency, the DoD OIG, and the intelligence agencies.

The DoD OIG also performed audit procedures on balances of 37 DoD Components that do not produce stand-alone financial reports. The balances for these 37 Components are consolidated into the Agency-Wide Basic Financial Statements.

As previously noted, the agency financial report includes more than financial statements and the related notes. Audit reports also describe whether the information provided in the financial statements and their related notes is reliable. While the Management Discussion and Analysis, Required Supplementary Stewardship Information, Required Supplementary Information, Other Information, and Appendix sections in the financial report are not required to be audited, they are still important aspects of the financial report and are helpful in gaining a better understanding of the information in the financial statements.

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<sup>2</sup> Of the 21 DoD Components’ financial statement audits overseen by the DoD OIG, 2 audits are completed on funds that are provided (sub-allotted) by DoD Components to the U.S. Army Corps of Engineers. For FY 2018, USACE presented financial statements for two sub-allotted funds which were audited and received unmodified opinions; however, these are not included in the 63 DoD entities that are consolidated into the Agency-Wide financial report. See Table 1 in the “FY 2018 DoD Financial Statement Audit Results” section of this report for a list of DoD Component financial statement audits.

## **B. The Importance of Audited Financial Statements**

Audits of the Agency-Wide and DoD Components' financial statements are important for several reasons. First, the audits provide Congress and the public an accurate assessment of where the DoD spends its funds. The audits also provide transparency on where DoD resources are spent.

In addition, although financial statement audits are not designed to detect waste, fraud, and abuse, auditors remain alert throughout the process and take appropriate action, such as referring the matter to investigative agencies, when they uncover or suspect waste, fraud, or abuse is occurring. Moreover, the audits can assist in deterring and detecting waste, fraud, and abuse by baselining, or determining a starting point for the costs and rate of spending for analysis and comparison and planning for the costs and rate of spending, operations. Having a baseline allows management to detect anomalies that could help identify waste, fraud, and abuse.

Furthermore, a significant function of financial statement audits involves reviewing information technology and cyber security. Many of the systems crucial to financial management and reporting are also used for operational purposes. Therefore, testing during the financial statement audits of DoD information technology systems and interfaces between information technology systems can identify vulnerabilities in those systems and result in recommendations to improve the DoD's cyber security. Without effective internal controls and proper cyber security, the systems that the DoD relies on to conduct military operations could be compromised and potentially undermine DoD operations.

Financial statement audits can also help management improve DoD operations. The audits provide feedback regarding the effectiveness of each reporting entity's business systems, processes, and controls. For example, when auditing the completeness of inventory at the Defense Logistics Agency, the auditors not only examine the systems used to process inventory, but also review the business processes used for ordering, receiving, and storing the inventory. In addition, the auditors review the internal controls in place to ensure that they are designed and operating effectively to ensure the accuracy of inventory information, to include its quantity, location, and condition. Knowing where the DoD's property, spare parts, munitions, and equipment is located, how much the DoD has on hand, and what its condition is, affects DoD operations. Accurate inventories ensure that the DoD has the equipment it needs and does not buy too much or too little.

Another important impact of the financial statement audits relates to the DoD's development of business processes. The audit can help improve the DoD's business processes, such as its ability to more accurately forecast and determine the most efficient and effective uses of its funds. For example, if the DoD knows that the asset values and counts are correct, it can properly allocate funds and reduce excess purchases and costs. It can also better predict how much funds it needs for certain purposes, and where unneeded funds can be reallocated and put to better use.

Ultimately, the audits can improve operational decision-making throughout the DoD. In short, the audits provide the DoD a better understanding of the risks for waste, fraud, and abuse; enable improvements to operations through more efficient business systems, processes, and controls; and allow more accurate and consistent information from the DoD Components. Ultimately, the DoD can improve its strategic decisions, such as allocating resources, deploying new systems, and implementing new policies, by having more accurate and complete information in the financial statements.

## **1. *Size of the DoD and Relationship to the Government-Wide Financial Statement Audit***

The DoD is the largest agency in the Federal government. It employs 2.9 million military and civilian employees at approximately 4,800 DoD sites located in 160 countries. In FY 2018, the DoD reported that it received congressional appropriations of \$863.6 billion. Approximately \$193 billion of the appropriations is considered mandatory, and the remaining \$670.6 billion is discretionary.<sup>3</sup> The DoD's discretionary spending is almost half of the total U.S. Government's discretionary funding. In addition, the DoD owns the majority of the U.S. Government's financial assets—in FY 2018, it reported \$2.7 trillion in assets, which is approximately 77 percent of total government assets.

The Government Accountability Office is responsible for conducting the annual audit of the Consolidated Financial Statements of the U.S. Government. The DoD's size and its disclaimers of opinion, is one of the contributing factors to the Government receiving a disclaimer of opinion. While other factors also contribute to the disclaimer of opinion on the Government-wide financial statements, the Government will likely continue to receive a disclaimer of opinion until the DoD improves its financial reporting.

## **2. *Requirements for Audited Financial Statements***

The Chief Financial Officers Act of 1990 (CFO Act of 1990) requires that Federal agencies prepare financial statements and have those financial statements audited by the agency's Inspector General or by an independent external auditor, as determined by the agency's Inspector General. While FY 2018 is the first year that the DoD has undergone a full financial statement audit, it is not the first year that the DoD has produced financial statements or the first time Components of the DoD have been audited.

The DoD began submitting financial statements for the Department of the Army to be audited, beginning in FY 1991. The DoD began submitting the Agency-Wide financial statements for audit in FY 1996.

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<sup>3</sup> The total dollar amount of mandatory funding is set by formulas established by Congress, such as contributions for military retirement and health benefits. The dollar amount of discretionary funding, otherwise known as budget authority, is determined by Congress on an annual basis and is used to pay most DoD expenses such as payroll, inventory, and equipment.

The DoD OIG only performed limited scope audits on the financial statements for FYs 1996 through 2001. Although those audits were limited in scope, the DoD OIG performed steps above and beyond those required to render a disclaimer of opinion according to generally accepted government auditing standards. The purpose of these audit steps was to provide the DoD feedback on its financial processes and controls. However, these audits were limited in scope because the DoD accounting systems produced unreliable data and financial statements; therefore, the DoD OIG was unable to obtain sufficient appropriate audit evidence on which to base an opinion, resulting in disclaimer of opinions.

Beginning in FY 2002 and continuing through FY 2018, Congress established requirements and due dates for the DoD audit readiness efforts, including:

- establishing reporting requirements to assist in monitoring DoD financial improvement efforts,
- requiring specific financial statement audits, and
- establishing audit readiness milestones.

For example, the National Defense Authorization Act for FY 2002 limited the audit procedures that the DoD OIG was allowed to perform on the DoD's financial statements. The Act only allowed the DoD OIG to perform the procedures required by generally accepted government auditing standards and limited the DoD OIG to auditing only the information that DoD management stated was ready for audit. Prior to FY 2018, only a limited number of DoD Components asserted that their information was ready for audit, such as the Military Retirement Fund financial statements and the U.S. Army Corps of Engineers-Civil Works financial statements.

The National Defense Authorization Act for FY 2010 required the DoD to develop and maintain a semi-annual plan, known as the Financial Improvement and Audit Readiness (FIAR) Plan, which is prepared by the FIAR Directorate.<sup>4</sup> The FIAR Directorate is located within the Office of the Under Secretary of Defense (Comptroller). Its purpose is to lead the DoD's improvement of its financial management processes. The FIAR Directorate also developed and tracked the progress of the FIAR Plan, which reported on the DoD's efforts to become audit ready. The Plan was intended to assist the DoD improve its internal controls over financial reporting and resolve material weaknesses in the financial reports. Additionally, the FIAR Plan set milestones for resolving problems that affect the accuracy, reliability, and timeliness of the DoD's financial information.

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<sup>4</sup> Beginning in FY 2018, the Financial Improvement and Audit Readiness Directorate became the Financial Improvement and Audit Remediation Directorate.

The National Defense Authorization Act for FY 2012 further required the FIAR Plan to include interim objectives and a schedule of milestones to support the DoD's goal for the Statement of Budgetary Resources to be validated for audit by September 30, 2014. The DoD OIG began auditing DoD Components' Statements of Budgetary Activity in FY 2014.<sup>5</sup>

The National Defense Authorization Act for FY 2014 required the Secretary of Defense to ensure that an annual full-scope audit be performed over the DoD financial statements beginning in FY 2018.

The National Defense Authorization Act for FY 2016 required the DoD OIG to obtain independent external auditors to audit the DoD Component financial statements. As the overall auditor of the Agency-Wide Basic Financial Statements, the DoD OIG oversees these audits and performs additional procedures necessary to support the overall audit opinion on the Agency-Wide Basic Financial Statements. The DoD OIG contracted with five independent public accounting firms to perform a total of 21 financial statement audits in FY 2018.

The National Defense Authorization Act for FY 2018 replaced the requirement for the FIAR Plan with the Financial Improvement and Audit Remediation Plan. The intent of the Remediation Plan is to describe the specific actions the DoD plans to take to address the notifications of findings and recommendations (NFRs) that the auditors issue on the weaknesses in the DoD's business processes and financial statements that the audits identify. The Remediation Plan provides interim milestones for completing those actions and cost estimates for the remediation actions.

### *DoD Components that Received Audits in FY 2018*

For the FY 2018 financial statement audits, the Office of Management and Budget required the DoD to submit audited financial statements at nine DoD Components and at the DoD Agency-Wide level. The DoD OIG therefore contracted and oversaw the independent public accounting firms' financial statement audits for the following nine DoD Components.

- Department of Army General Fund
- Department of Army Working Capital Fund
- U.S. Navy General Fund
- Department of Navy Working Capital Fund
- Department of Air Force General Fund
- Department of Air Force Working Capital Fund
- U.S. Marine Corps General Funds
- Military Retirement Fund
- U.S. Army Corps of Engineers Civil Works Program

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<sup>5</sup> The Statement of Budgetary Activity is a limited schedule related to the Statement of Budgetary Resources. Similar to the Statement of Budgetary Resources, the Statement of Budgetary Activity includes information about how the DoD received its budgetary resources; however, unlike the Statement of Budgetary Resources, the information is not cumulative. Rather, the Statement of Budgetary Activity included only one or two years' information.

In addition to these 9 required audits of DoD Components, the DoD decided that 19 additional DoD Components would submit audited financial statements because the Components' financial statements were material to the Agency-Wide financial statements. These additional 19 components included, among other Components, the:

- Defense Information Systems Agency General Fund and Working Capital Fund,
- U.S. Transportation Command Working Capital Fund, and
- Defense Logistics Agency General Fund, Working Capital Fund, and National Defense Stockpile Trust Fund.

The DoD OIG oversaw the IPA audits for 12 of the 19 stand-alone financial statement audits. The other seven audits were completed by independent public accounting firms who were contracted for and monitored by the entity under audit or their respective Office of Inspector General.<sup>6</sup>

### ***3. Assertions Made by the Secretary of Defense and Under Secretary of Defense (Comptroller)/Chief Financial Officer***

To comply with the National Defense Authorization Act of 2014, on September 27, 2017, the Secretary of Defense and the DoD CFO notified the DoD Inspector General that the DoD's FY 2018 financial statements were ready for audit. The Secretary and DoD CFO asserted that:

the DoD has the following capabilities (i.e., processes and systems) in place that allow an auditor to scope and perform an audit of full financial statements, that results in actionable feedback on:

- Universe of Transactions – The DoD can provide detailed accounting transactions for material financial statement line items;
- Fund balance with Treasury – The DoD can provide processes to reconcile fund balance with the Department of the Treasury;
- Journal vouchers – The DoD can provide a list of material journal vouchers and support;
- Existence, completeness, and rights and obligations and valuation of assets – The DoD can provide asset populations and has applied alternative valuation methods to certain asset categories; and
- Environmental and disposal liabilities for real property and general equipment – The DoD has identified and valued its liabilities.

Although the Secretary and DoD CFO stated that the DoD was ready for audit, they also acknowledged that the DoD did not expect an unmodified audit opinion on its Agency-Wide consolidated financial statements, and that the DoD was not certifying that the DoD or Component financial statements were reliable. Rather, the Secretary and DoD CFO stated

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<sup>6</sup> These seven audits were for the Defense Finance and Accounting Service, the Defense Contract Audit Agency, the Defense Commissary Agency, the DoD OIG, and the Defense intelligence agencies.

that the DoD was prepared to support the audit procedures and that they expected to receive findings and recommendations regarding the weaknesses and inefficiencies in the DoD's financial management processes.

#### **4. Financial Statement Audits and Potential Results**

As noted above, the fundamental purpose of a financial statement audit is to provide independent assurance that DoD management has presented an accurate and fair view of its financial performance. The audit also identifies areas where management could improve its controls and processes to enhance its operations.

The DoD OIG conducted the audit of the FY 2018 DoD Agency-Wide Basic Financial Statements to:

- express an opinion on whether the consolidated financial statements were fairly presented in accordance with Generally Accepted Accounting Principles;
- report any material weaknesses or significant deficiencies in internal control over financial reporting; and
- report on compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements that were tested.

When performing a financial statement audit, the auditor can express one of four potential results on the financial statements.

1. unmodified opinion
2. qualified opinion
3. adverse opinion
4. disclaimer of opinion

An unmodified opinion, sometimes referred to as a clean opinion, is expressed when the auditor concludes that management has presented the financial statements fairly and in accordance with Generally Accepted Accounting Principles.

A qualified opinion is expressed when the auditor concludes that there are misstatements in the financial statements which are material to the financial statement but are not significant to the overall presentation of the financial statements.<sup>7</sup>

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<sup>7</sup> For example, for FY 2018, the auditor issued a qualified opinion on the financial statements of the DoD's Medicare-Eligible Retiree Health Care Fund because the auditors could not obtain evidence to support the cost of care provided by DoD-managed Military Treatment Facilities. These costs were based on estimates and not in accordance with accounting standards. The auditor concluded that these estimated costs were material to the financial statements because they were 22 percent of the total liabilities and 28 percent of program costs on the financial statements. Except for these amounts, however, the financial statements were presented fairly in all material respects, which allowed the auditor to issue a qualified opinion.

An adverse opinion is expressed when the auditor concludes that misstatements in the financial statements are both material and significant to the financial statements. Neither the DoD nor any DoD Component has received an adverse opinion since the DoD OIG has been auditing or overseeing the audits of the DoD.

A disclaimer of opinion is expressed when the auditor is unable to obtain sufficient appropriate audit evidence on which to base an opinion. This opinion is the most common opinion for the DoD and the DoD Component financial statements. In FY 2018, the DoD OIG issued a disclaimer of opinion on the Agency-Wide Basic Financial Statements because multiple DoD Components that account for the majority of the balances consolidated into the Agency-Wide Basic Financial Statements received disclaimers of opinion.<sup>8</sup> This included the Department of the Army General Fund, Department of the Navy General Fund, Department of the Air Force General Fund, U.S. Marine Corps General Fund, Department of the Army Working Capital Fund, Department of the Navy Working Capital Fund, and Department of the Air Force Working Capital Fund. These DoD Components received disclaimers of opinion because they continued to have unresolved accounting issues and material weaknesses that prevented them from providing evidence to support the balances presented on the financial statements.

However, financial statement audits not only determine and provide an overall opinion on the accuracy of the financial statements, they also identify weaknesses and inefficiencies in the financial management processes and controls. Auditors classify weaknesses and inefficiencies in internal controls based on the severity of the weakness. The classifications include material weaknesses, significant deficiencies, and control deficiencies.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting that results in a reasonable possibility that management will not prevent, or detect and correct, a material misstatement in the financial statements in a timely manner.

A significant deficiency is less severe than a material weakness, but important enough to bring to management's attention. Control deficiencies are noted weaknesses or deficiencies that auditors bring to the attention of management that typically do not have an impact on the financial statements but which could improve the business processes of the agency.

The following are examples of material weaknesses that were identified in the Audit of the FY 2018 DoD Agency-Wide Basic Financial Statements.

- Insufficient processes and internal controls to ensure complete and accurate Component financial statements, including related note disclosures that were prepared prior to the compilation of the Agency-Wide financial report, which resulted in inaccurate account balances being consolidated in the Agency-Wide Basic Financial Statements.

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<sup>8</sup> DoD Components that received disclaimers of opinion, in total, are 56.1 percent of the reported DoD assets and 89.8 percent of the reported DoD budgetary resources.

- Not accumulating cost information and recording transactions using a method that is allowed by accounting standards.
- Not having effective oversight and monitoring to ensure that the DoD developed corrective action plans for all material weaknesses.

We list below all the material weaknesses auditors identified in the DoD's FY 2018 financial statements and discuss some of the most important ones in more detail.

## **C. Roles and Responsibilities Related to the Financial Statement Audit**

The following sections briefly describe the roles and responsibilities of the various individuals and entities involved in the audit of the DoD's financial statements.

### **1. Secretary of Defense and Under Secretary of Defense (Comptroller)/Chief Financial Officer**

The Secretary of Defense, in conjunction with the Under Secretary of Defense Comptroller/Chief Financial Officer (the DoD CFO), is responsible for compiling and presenting the DoD Agency-Wide Basic Financial Statements.

This responsibility includes, but is not limited to, the following:

- Developing and overseeing implementation of DoD-wide accounting and finance policies;
- Overseeing and monitoring effective financial management processes, data, and systems;
- Assisting DoD Components working to remediate audit findings;
- Maintaining effective internal controls over financial reporting; and
- Presenting the financial statements in accordance with Generally Accepted Accounting Principles.

The Secretary of Defense and the DoD CFO are also responsible for communicating the objectives and importance of DoD financial statement audits throughout the DoD.

In addition, the Secretary of Defense and the DoD CFO are responsible for preparing and signing the Management Representation Letter for the DoD Agency-Wide Basic Financial Statements. The Management Representation Letter contains a list of representations made by DoD management to the DoD OIG related to the preparation and presentation of financial statements and the effectiveness of internal controls on financial reporting. For example, in the FY 2018 Management Representation Letter, the Secretary of Defense and the DoD CFO stated that the FYs 2018 and 2017 DoD Agency-Wide Basic Financial Statements were not presented in conformity with Generally Accepted Accounting Principles.

The Management Representation Letter also contains representations related to internal controls, fraud, and compliance with applicable laws and regulations, such as the Antideficiency Act and the Federal Financial Management Improvement Act.

## ***2. Component Secretaries and Chief Financial Executives***

The DoD Components that are audited include the Offices of the Secretary of Defense, the Military Departments, the Chairman of the Joint Chiefs of Staff, the Combatant Commands, the DoD Office of Inspector General, the Defense agencies, the DoD field activities, and all other organizational entities in the DoD.

Each Component is responsible for ensuring that key processes, systems, internal controls, and supporting documentation affecting the Component's financial statements are complete and accurate. In addition, each Component is responsible for improving accounting and financial functions within their component. During the audit, the Components are also responsible for responding to document requests from the auditors.

The Components must maintain their accounting records and submit these records to DFAS for financial statement compilation and reporting. Each Component, with support from DFAS, is responsible for reviewing its financial statements and associated notes to ensure that the financial information is complete and accurate. Additionally, the Components are responsible for implementing and sustaining corrective actions to address deficiencies identified by auditors.

## ***3. Defense Finance and Accounting Service***

DFAS, which reports to the DoD CFO, is responsible for standardizing, consolidating, and improving accounting and financial functions throughout the DoD.

DoD Components rely heavily on DFAS processes for maintaining, compiling, and reporting their financial transactions. In addition, auditors must request and rely on data that is provided by DFAS to support the Components' financial statement audits because DFAS maintains DoD's financial reporting systems that support financial statement balances. Additionally, DFAS is responsible for preparing the draft and final versions of the DoD Agency-Wide Basic Financial Statements, which are included in the financial report.

## ***4. DoD Office of Inspector General***

The DoD OIG is responsible for managing and completing the audits of the DoD Agency-Wide Basic Financial Statements. Additionally, the DoD OIG is responsible for monitoring and overseeing the IPA firms' that conduct financial statement audits of the DoD Components.

The DoD OIG consolidates data and results from the independent public accounting firms and uses the results to support the conclusions in the DoD OIG's audit of the DoD Agency-Wide Basic Financial Statements. The DoD OIG is required to report these audit results to the GAO, OMB, and the Department of the Treasury.

OMB issues guidance to the executive branch on how to prepare financial statements and conduct financial statement audits.

The Treasury consolidates all financial statements and prepares the Government-Wide financial report and provides the statements to the GAO.

## **5. *Independent Public Accounting Firms***

The DoD OIG contracts with independent public accounting firms to perform DoD Components' financial statement audits. The independent public accounting firms submit contract proposal packages that are reviewed by a panel of DoD officials, composed of representatives from the DoD OIG, DoD contracting specialists, and the Component being audited. The independent public accounting firms' proposal packages include a price quote, their prior experience, their technical understanding of the subject area, and their proposed staff and resumes. Excluding price, the DoD OIG and Component personnel evaluate each proposal on its own merits and provide the contracting specialist a recommendation. The contracting specialist then takes the recommendation and factors in the price quote to determine which independent public accounting firm receives the contract based on the best value to the government.

The independent public accounting firms must perform the audits of the Component's financial statements in accordance with both the generally accepted auditing standards that are issued by the Comptroller General of the United States and with the audit requirements for Federal financial statements that are issued by the Office of Management and Budget.

In their audits, the IPA firms test the design and effectiveness of internal controls and the accuracy and completeness of transactions and balances. IPA firms are required to provide opinions as to whether the Components' presentation of the financial statements conform with Generally Accepted Accounting Principles.

The DoD OIG monitors and oversees the work of the IPA firms throughout the audit. This oversight includes attending meetings between the IPA firm and the Component being audited, reviewing the IPA firms' testing results, and verifying that the work performed by the PA firms complies with contract requirements and auditing standards.

The IPA firms provide the DoD OIG the results of their testing for review and consolidation into the DoD Agency-Wide Basic Financial Statements. The IPA firms also provide financial improvement and audit remediation support to the DoD and its Components, such as monitoring material weaknesses and corrective action plans for the Components.

## **6. Government Accountability Office**

The GAO is responsible for conducting the annual audit of the Consolidated Financial Statements of the U.S. Government. The Department of the Treasury prepares the Government-Wide financial report, which represents the aggregation of the financial statements for all components of the U.S. Government. Just as the Consolidated Financial Statements aggregate the financial statements of the U.S. Government's components, the GAO's audit of the Consolidated Financial Statements aggregates the audit opinions of the Inspectors General and IPA firms who audit the U.S. Government's components.

The GAO is also responsible for monitoring and evaluating the audit work of the Inspectors General and IPAs for the significant U.S. Government components. The results of the Components' audits are incorporated into the GAO's audit of the Consolidated Financial Statements.

The GAO issued a disclaimer of opinion on the FY 2017 Consolidated Financial Statements, due in part to the results of the audit of the DoD's financial statements.

## **D. The Results of the DoD OIG's Audit of the DoD's FY 2018 Financial Statements**

As noted previously, the CFO Act of 1990 requires the DoD OIG to audit the DoD Agency-Wide consolidated balance sheet, consolidated statement of net cost, consolidated statement of changes in net position, combined statement of budgetary resources, and notes to the basic statements.

In addition to the opinion report on the basic financial statements, the DoD OIG issues a report on the agency's internal control over financial reporting, compliance with the requirements of Federal financial management systems requirements, and compliance with applicable laws, regulations, contracts, and grant agreements.

### **1. FY 2018 DoD Financial Statement Audit Results**

During FY 2018, the DoD OIG completed or oversaw the completion of 21 DoD Component financial statement audits and the audit of the FY 2018 DoD Agency-Wide Basic Financial Statements. The DoD OIG contracted with six IPA firms to support the overall effort to audit the Agency-Wide and Component financial statements. The IPAs were Ernst & Young, LLP; Kearny & Company; Cotton & Company, LLP; Grant Thornton, LLP; KPMG, LLP; and RMA Associates.

Collectively, these IPA firms assigned over 1,000 auditors to perform the audits of the DoD components. The DoD OIG assigned over 150 auditors to oversee the work of the IPA firms, to conduct individual audits of Components, and to complete the Agency-Wide Basic Financial Statement audit.

According to the DoD CFO, this was one of the largest financial statement audits in history. The DoD CFO reported that the audit cost approximately \$413 million, with \$192 million of that paid to the independent public accounting firms, and the remainder covering government costs to support the audits.

However, the scope of the audit was also massive. In total, DoD OIG and IPA auditors visited over 600 DoD locations, sent over 40,000 requests for documentation, and tested over 90,000 sample items for the audits of the DoD and its Components.

As a result of the site visits, testing, and reviews of DoD documents, the DoD OIG and IPA auditors issued over 2,000 NFRs related to DoD financial statements. The auditors issue NFRs throughout the audit to communicate to management in a timely manner any identified weaknesses and inefficiencies in financial processes, the impact of these weaknesses and inefficiencies, the reason the weaknesses and inefficiencies exist, and recommendations to management on how to correct the weaknesses and inefficiencies.

As explained above, auditors classify the weaknesses and inefficiencies in financial processes based on the severity of the weakness. The classifications include material weaknesses, significant deficiencies, and control deficiencies. Material weaknesses and significant deficiencies are presented in the auditor's report on internal control of financial reporting. Control deficiencies are provided to management throughout the audit, and a summary of the control deficiencies is provided after the completion of the audit.

#### *a) FY 2018 DoD Component Audit Results*

Of the 21 DoD reporting entities, 5 received unmodified opinions, 1 received a qualified opinion, 13 received disclaimers of opinion, and 2 audits have not been completed. Specifically, auditors have not completed the audits of the Defense Information Systems Agency General Fund and Working Capital Fund due to complications in testing Fund Balance with Treasury (FBWT). These audit opinions are expected to be released in January 2019. Table 1 provides a list of DoD reporting entities and the results of the audits overseen by the DoD OIG in FY 2018.

*Table 1. FY 2018 Financial Statement Opinions for DoD Reporting Entities*

Reporting Entity	Opinion
U.S. Army Corps of Engineers-Civil Works	Unmodified
Defense Health Agency-Contract Resource Management	Unmodified
Military Retirement Fund	Unmodified
Army Sub-Allotted	Unmodified
Defense Logistics Agency Sub-Allotted	Unmodified
Medicare-Eligible Retiree Health Care Fund	Modified
Department of the Army GF	Disclaimer
Department of the Army WCF	Disclaimer
U.S. Navy GF	Disclaimer
Department of the Navy WCF	Disclaimer
Department of the Air Force GF	Disclaimer
Department of the Air Force WCF	Disclaimer
U.S. Marine Corps GF	Disclaimer
Defense Health Program GF	Disclaimer
Defense Logistics Agency GF	Disclaimer
Defense Logistics Agency WCF	Disclaimer
Defense Logistics Agency Transaction Fund	Disclaimer
U.S. Special Operations Command GF	Disclaimer
U.S. Transportation Command WCF	Disclaimer
Defense Information Systems Agency GF	Delayed
Defense Information Systems Agency WCF	Delayed

**Legend:**

GF – General Fund

WCF – Working Capital Fund

Source: DoD OIG.

In their notification of audit readiness to the DoD Inspector General, the Secretary of Defense and the DoD CFO stated that they expected to receive actionable feedback on various financial areas, including existence, completeness, and valuation of certain assets. This is what occurred. As a result of the site visits, testing, and reviews of DoD documents, as of November 30, 2018, the DoD OIG and IPA auditors issued 2,410 NFRs to the DoD and its Components. Table 2 presents the number of NFRs issued by DoD Component.

Table 2. Number of Notifications of Finding and Recommendations by Component as of November 30, 2018<sup>1</sup>

Reporting Entity	Financial NFRs – New	Financial NFRs – Reissued <sup>2</sup>	IT NFRs – New	IT NFRs – Reissued <sup>2</sup>	Total Issued FY 2018 NFRs
Department of the Army	132	102	64	93	391
Department of the Navy	191	21	246	52	510
Department of the Air Force	128	50	96	73	347
U.S. Marine Corps	26	61	22	48	157
U.S. Army Corps of Engineers	9	26	1	5	41
Defense Health Program	72	0	52	0	124
Defense Information Systems Agency	2	0	16	0	18
Defense Logistics Agency	108	195	24	26	349
U.S. Special Operations Command	38	10	31	22	101
U.S. Transportation Command	111	0	54	0	165
Defense Health Agency– Contract Resource Management	1	0	13	0	14
Medicare-Eligible Retiree Health Care Fund	0	2	14	0	16
Military Retirement Fund	1	1	8	0	10
Agency-Wide	4	0	159	0	163
<b>Total</b>	<b>823</b>	<b>468</b>	<b>800</b>	<b>319</b>	<b>2,410</b>

<sup>1</sup> Auditors continued to issue NFRs in December 2018. Therefore, the table numbers do not reflect all NFRs issued as a result of the FY 2018 financial statement audits.

<sup>2</sup> NFRs are considered reissued if the weakness or inefficiency noted in the NFR was identified during a prior year audit but which the DoD Component had not yet corrected.

Source: DoD OIG.

Auditors classified the NFRs based on the severity of the weaknesses. The classifications resulted in the identification of 129 material weaknesses across the Components, as shown in Table 3, many of which are similar between Components. For example, most Components have material weaknesses related to IT, such as inadequate controls over access, system changes, and security management of the IT systems.

In addition, DoD Components had 37 instances of non-compliance with laws and regulations, as shown in Table 3. Similar to material weaknesses, many of the instances of non-compliance with laws and regulations are similar between Components. For example, most Components did not fully comply with the Federal Managers’ Financial Integrity Act of 1982 or the Federal Financial Management Improvement Act of 1996.

Table 3 provides the number of material weaknesses and the number of non-compliances for each of the Component audits overseen by DoD OIG.

*Table 3. Component Audit Results*

Entity	Material Weaknesses	Non-Compliance
Department of the Army GF	12	3
Department of the Army WCF	12	2
U.S. Navy GF	14	2
Department of the Navy WCF	10	2
Department of the Air Force GF	11	2
Department of the Air Force WCF	12	2
U.S. Marine Corps GF	9	4
U.S. Army Corps of Engineers-Civil Works	2	2
Defense Health Program GF	13	4
Defense Information Systems Agency GF	Delayed	Delayed
Defense Information Systems Agency WCF	Delayed	Delayed
Defense Logistics Agency GF	6	2
Defense Logistics Agency WCF	8	2
Defense Logistics Agency Transaction Fund	6	2
U.S. Special Operations Command GF	5	2
U.S. Transportation Command WCF	5	1
Defense Health Agency-Contract Resource Management	0	0
Medicare-Eligible Retiree Health Care Fund	1	1
Military Retirement Fund	0	0
Army Sub-Allotted	2	2
Defense Logistics Agency Sub-Allotted	1	2
<b>Total</b>	<b>129</b>	<b>37</b>

**Legend:**

GF – General Fund

WCF – Working Capital Fund

Source: DoD OIG.

## b) FY 2018 DoD Audit Results

On November 15, 2018, the DoD OIG issued a disclaimer of opinion on the FY 2018 Agency-Wide Basic Financial Statements, meaning an overall opinion could not be expressed on the financial statements under audit. After compiling over 2,400 DoD Component NFRs and 129 DoD Component material weakness, the DoD OIG identified 20 Agency-Wide material weaknesses.

Table 4 provides a list of the 20 Agency-Wide material weaknesses and a brief summary of each weakness. Below the table, we provide a more in-depth analysis of six of the most significant material weaknesses.

*Table 4. Agency-Wide Material Weaknesses Identified During the FY 2018 Financial Statement Audit*

Material Weakness	Description
Financial Management Systems and Information Technology	The DoD had wide-ranging weaknesses in financial management systems that prevented the DoD from collecting and reporting financial and performance information that is accurate, reliable, and timely.
Universe of Transactions	The DoD was unable to provide a complete universe of transactions that reconciled to its accounting records.
Financial Statement Compilation	The DoD lacked sufficient processes and internal controls to ensure that complete and accurate Component financial statements, including related note disclosures, were prepared prior to the compilation of the Agency-Wide Annual Financial Report.
Fund Balance with Treasury	The DoD had ineffective processes and controls for reconciling its Fund Balance with Treasury.
Accounts Receivable	The DoD did not have proper controls to record and report transactions that should have been labeled as a receivable.
Operating Material & Supplies	The DoD was unable to report Operating Material and Supplies in accordance with Generally Accepted Accounting Principles (GAAP).
Inventory and Related Property	The DoD lacked the systems and controls necessary to provide assurance over the existence, completeness, and valuation of inventory recorded in the financial statements.
General Property, Plant & Equipment	The DoD could not record General Property, Plant, and Equipment at acquisition or historical cost, establish or support ownership of the assets, or determine the value.
Government Property in Possession of Contractors	The DoD lacked policies, procedures, controls, and supporting documentation over the acquisition, disposal, tracking, and inventory processes of Government property in the possession of contractors.
Accounts Payable	The DoD did not have the financial management system capabilities to properly record accounts payable transactions.
Environmental and Disposals Liabilities	The DoD was unable to develop accurate estimates and account for Environmental Liabilities in accordance with GAAP.

*Table 4. Agency-Wide Material Weaknesses Identified During the FY 2018 Financial Statement Audit (cont'd)*

Material Weakness	Description
Legal Contingencies	The DoD did not provide the necessary supporting documentation for auditors to determine if the legal contingences were accurately presented in the notes to the financial statements.
Beginning Balances	The DoD did not have the historical data to support beginning balances or the ability to reconcile beginning balances to closing balances at the end of the reporting period.
Journal Vouchers	The DoD recorded over 1,200 journal vouchers, totaling over \$175 billion, that were not fully supported and which directly affected the financial statements.
Intragovernmental Eliminations	The DoD could not accurately identify, provide supporting documentation, or fully reconcile its intragovernmental transactions.
Statement of Net Costs	The DoD did not accumulate cost information and record transactions in compliance with GAAP.
Reconciliation of Net Cost of Operations to Budget	The DoD was unable to reconcile its budgetary and proprietary data.
Budgetary Resources	The DoD was unable to accurately determine its total budgetary resources available or the status of those resources.
Entity Level Controls	The DoD did not have sufficient entity level controls to establish an internal control system that would produce reliable financial reporting.
Oversight and Monitoring	The DoD did not have effective oversight and monitoring to ensure that the DoD Components developed and implemented corrective action plans for all material weaknesses.

Source: DoD OIG.

In addition to these material weaknesses, the DoD OIG identified five instances of non-compliance with laws and regulations across the DoD. Specifically, the DoD did not comply with the Federal Managers' Financial Integrity Act of 1982, the Federal Financial Management Improvement Act of 1996, the Antideficiency Act, the Federal Information Security Modernization Act of 2014, and the Debt Collection Improvement Act of 1996.<sup>9</sup>

<sup>9</sup> These Federal Managers' Financial Integrity Act requires the DoD to perform ongoing evaluations and report on the adequacy of its systems of internal accounting and administrative control.

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

The Antideficiency Act prohibits the DoD from making or authorizing expenditures or obligations that exceeded the available appropriations or funds.

The Federal Information Security Modernization Act requires the DoD provide information security controls.

The Debt Collection Improvement Act requires the DoD transfer all outstanding eligible debt that is overdue by 120 days or more.

### *c) Significant DoD Material Weaknesses*

As noted in Table 4, the DoD OIG identified 20 Agency-Wide material weaknesses during the FY 2018 audit. DoD management is responsible for prioritizing the findings and corrective action plans to address these material weaknesses. Most of these weaknesses affect most of the DoD Components. Each can hinder the DoD's efforts to improve its business processes and achieve auditable financial statements and are critically important to correct.

In our judgment, six material weaknesses stand out as most significant.

1. Financial Management Systems and Information Technology (IT)
2. Universe of Transactions
3. Inventory
4. Property, Plant, and Equipment (PP&E)
5. Fund Balance with Treasury
6. Financial Statement Compilation

#### **(1) Financial Management Systems and Information Technology**

Within the DoD, financial transactions are rarely completed using only one IT system from the point of initiation to the point that the transactions are reported on the financial statements. In addition, DoD Components do not own and operate all of the IT systems that they use to process their financial transactions. In 2016, the DoD reported that it had nearly 400 separate IT systems to process accounting data. For example, to process and record contract payments, the Services depend on over a dozen IT systems that are owned and operated by other DoD Components.

Ineffective IT system controls can also result in significant risk to DoD operations and assets. For example, payments and collections could be lost, stolen, or duplicated as a result of weak IT controls. In addition, critical operations, such as those supporting national defense and emergency services, could be disrupted through weak IT controls. Across multiple DoD Components, auditors found significant control deficiencies regarding IT systems. Specifically, the auditors found that:

- required monitoring of sensitive user activities, including activities of privileged users was not documented or not being performed,
- access rights and responsibilities were not appropriately restricted according to segregation of duties policy,
- users access was not terminated in a timely manner when the users left the organization, and
- controls had not been implemented to identify unintentional or unauthorized changes made to applications, databases, or data.

For FY 2018, auditors issued over 1,000 NFRs related to the DoD's financial management systems and its IT systems. Most Components had either a material weakness related to financial management systems and the IT environment or both a material weakness and an instance of non-compliance with the Federal Financial Management Improvement Act of 1996.

Improving internal controls for IT systems that process financial transactions will also improve the cybersecurity of the DoD's IT systems. The DoD must defend its own networks, systems, and information from malicious cyber attacks. Improved internal controls on IT systems that process financial information will help the DoD both protect against and rapidly respond to cyber threats across different networks and systems.

The DoD is pursuing several initiatives to address weaknesses related to the IT systems. For example, the DoD Components plan to eliminate 26 legacy IT systems by FY 2022. The DoD CFO has established a database to identify IT applications that impact DoD financial statement audits and to track the auditor feedback regarding the system controls. However, to further address individual NFRs, the DoD needs to develop and implement more effective internal controls related to user accounts, segregation of duties, and IT security.

## **(2) Universe of Transactions**

A significant hurdle to progress on the DoD's financial statements is the DoD's inability to produce a complete, accurate, and reconcilable universe of transactions. A universe of transactions is a central repository of financial transactions, such as transactions related to the DoD's inventory, property, and payroll. The universe of transactions is compiled by combining all transactions from multiple accounting systems. In their audits, the DoD Components must be able to identify a universe of transactions that supports the information reported on the financial statements.

The DoD is experiencing significant challenges in providing an accurate universe of transactions due to the large number of transactions, systems, and owners of the financial data. Component auditors issued over 50 NFRs related to weaknesses in the universe of transactions in FY 2018. As a result of the weaknesses identified, the auditors classified the universe of transactions as a material weakness for six Components.

Specifically, the DoD and many of its Components were unable to provide a complete universe of transactions that reconciled to their accounting records. For example, auditors issued two NFRs on the universe of transactions to the U.S. Special Operations Command in FY 2018. The NFRs stated that the universe of transactions did not include data from all sources that contained U.S. Special Operations Command accounting records. Because U.S. Special Operations Command obtains data from various DoD Components to produce and support its financial statements, it is vital that it has controls in place to verify that it has obtained and incorporated all the relevant financial information. The auditors determined that the U.S. Special Operations Command did not verify that the financial records in the accounting systems were completely and accurately recorded on its financial statements.

The DoD's ability to produce a universe of transactions that is accurate and complete is important for several reasons – not only will it improve the DoD's financial statements, it will also improve its operations. For example, a complete and accurate universe of transactions will provide the DoD an opportunity to perform an analysis of its purchases, payments, and inventory, which could identify duplicate payments, excess purchases, excess inventory stockpiles, or other hidden or excessive costs. The DoD can also use accurate data from the universe of transactions to develop cost-control decisions so that programs and missions can be completed within the approved budget. For example, identifying all transactions in the Joint Strike Fighter Program would allow the program managers to determine the overall costs more accurately, which could result in identifying cost overruns sooner. Program managers could also better identify the cost overruns and develop plans based on an accurate universe of transactions to seek to put the program back within budget.

In an effort to develop a more accurate and complete universe of transactions, the DoD CFO is working with the DoD financial system owners to more accurately record financial transactions at the transaction level, which would significantly assist the DoD in producing a universe of transactions. Developing corrective action plans to ensure a complete and accurate universe of transactions is available to support financial statement balances is a key to obtaining a positive audit opinion.

### **(3) Inventory and Related Property**

The Military Services and DoD Components own inventory that they must report on their financial statements. The inventory can be in the custody of and managed by the Military Service or the DoD Component that owns the items or in the custody of and managed by another organization.

Inaccurate information in financial reporting can have significant consequences. For example, if a Military Service believes it has a low quantity of a spare part for an aircraft based on a service provider's inaccurate report or does not review the inventory held by others, the Service may decide to order additional parts that it does not need, which is a waste of funds. Conversely, if the Service inaccurately believes that it has a sufficient quantity of spare parts for an aircraft, it may not order additional spare parts, resulting in shortfalls of the parts and the inability of aircraft to be repaired rapidly, which can affect operational readiness.

In FY 2018 auditors issued over 70 NFRs related to inventory and related property. These NFRs indicated that DoD Components lacked adequate systems and controls necessary to provide assurance over the existence, completeness, and valuation of inventory recorded in the DoD's financial statements. For example, auditors found that items selected for testing:

- had been moved or used, but were still in the inventory records;
- were found in the warehouse but not listed in the inventory records;
- were recorded as in good condition but were actually unserviceable; and
- did not have supporting documentation to demonstrate ownership.

Several of the deficiencies found, if corrected, could not only improve the financial management of inventory but could also improve the DoD's readiness. Auditors issued several NFRs regarding inventory and related property that could have operational impact, such as:

- 107 rotor blades used for Blackhawk helicopters that could not be used but which remained on the inventory records,
- 1 aircraft door that was not included in the inventory records,
- 24 Gyro Electronics for military aircraft that were included in the inventory records but which were in a disposal status, and
- 20 fuel injector assemblies for Blackhawk helicopters that did not have supporting documentation to demonstrate which Military Service owned the assets.

To address the weaknesses with its inventory processes, the DoD must develop and implement policies, procedures, and internal controls to verify the existence, completeness, and valuation of inventory. Currently the DoD is updating policy and developing procedures for the Components to perform periodic inventory counts and reconciliations to validate that the systems have accurate inventory information.

In addition to these actions and as discussed below, the DoD implemented a database to track NFRs and associated corrective action plans. Corrective action plans pertaining to inventory should be tracked and shared across Components to ensure that the DoD Components are implementing new processes, controls, and best practices throughout the DoD.

#### **(4) General Property, Plant, and Equipment**

General Property, Plant and Equipment (PP&E) on the financial statements consists of tangible assets valued at \$100,000 or more at the time of purchase or construction that are intended for use by the Component that acquired or constructed it and that can be used for two or more years.<sup>10</sup> General PP&E includes things such as land, buildings, structures, facilities, and military equipment used to support the DoD's mission.

On the FY 2018 balance sheet, the DoD reported the value of General PP&E as \$758.8 billion, which is the second largest category of assets on the DoD's balance sheet in FY 2018. Due to the size, age, and locations of the General PP&E, however, the DoD faces challenges in verifying that General PP&E assets have been properly inventoried. In addition, the DoD has struggled to obtain evidence to support how much the DoD paid for the assets. This is especially difficult with historical assets, such as radar devices, communication equipment, excavating vehicles, and Vietnam-War era aircraft, because the original documentation establishing the value of the assets no longer exists.

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<sup>10</sup> There are varying capitalization thresholds across the Components, with some thresholds higher than \$100,000.

Auditors issued over 100 NFRs related to General PP&E in FY 2018. For example, auditors issued an NFR to the U.S. Air Force because the list of facilities (i.e., buildings or structures) in the property records was not complete or accurate. Specifically, the auditors found instances in which facilities had been physically demolished but which remained on the property records and were listed as active facilities. Auditors also found facilities that physically existed but which were not listed in the property records.

In another example, auditors issued an NFR to the Army related to the Army's real property inventory process, stating that the Army did not monitor the implementation of its physical inventory policy for real property. As one example, the Army installation located at Fort Belvoir, Virginia, had not verified that all real property was recorded in its property management system or ensure that the real property that was in its property management system actually existed.

Inaccurate and incomplete property systems can lead to wasteful costs to replace items that already exist or equipment that is sitting idle that could be used. Without accurate records, the DoD does not know what equipment it has, the equipment's condition, and what equipment it needs to buy to support the readiness of its military forces.

To address General PP&E process weaknesses, the DoD needs to improve internal controls related to management reviews, reconciliations, retention of supporting documentation, and timely recording of General PP&E transactions in the property and financial management systems.

The DoD has developed many corrective action plans related to General PP&E. For example, the DoD has directed its Components to validate its asset listing for completeness and accuracy. However, the DoD must ensure those processes and controls are documented and effectively implemented.

## **(5) Fund Balance with Treasury**

The Fund Balance with Treasury (FBWT) is composed of hundreds of individual accounts maintained by the Department of the Treasury that reflect the funds available for the DoD to spend. In other words, FBWT is the DoD's cash balance reported by its bank – the Department of the Treasury. However, the DoD continues to struggle with its processes to reconcile its FBWT accounts.

Deposits and payments made by the DoD Components increase or decrease the DoD's FBWT balance. Each DoD Component maintains its individual FBWT balances in its accounting systems, similar to a personal checkbook. The DoD Components have the critical task of reconciling their checkbooks to their bank accounts on a monthly basis to ensure that the Components have accounted for all of their deposits and payments. However, auditors continue to find weaknesses in the Component's reconciliation process.

Auditors issued over 60 NFRs related to the FBWT in FY 2018. The FBWT was a material weakness for 12 Components and was the reason for the delay in issuing the Defense Information System Agency General Fund and Working Capital Fund audit opinions. For example, auditors issued two NFRs identifying that the Defense Health Program and DFAS did not have a complete and documented reconciliation process for the Defense Health Program FBWT account. Additionally, the NFR stated that DFAS was unable to confirm that payments and collections that did not have supporting documentation but that were in the accounting system were correctly included in the Defense Health Program FBWT balance.

Without an accurate checkbook balance—its FBWT—the DoD’s spending decisions could result in an over- or under-utilization of its funds. For example, if a DoD Component has an inaccurate assessment of its FBWT and believes it will overspend its budgetary resources, it might not hire sufficient staff to execute its mission. Similarly, an inaccurate FBWT could lead the Component to delay procurement of needed inventory, which could lead to degraded equipment.

To address the weaknesses in the FBWT process, the DoD needs to develop, document, and implement policies and procedures to identify and resolve differences between the Treasury, disbursing system records, and accounting system records, at the transaction level. The DoD has developed several corrective actions to seek to establish and maintain an accurate FBWT balance. For example, the DoD is developing a process to track and reconcile activity (collections and disbursements) from the financial IT systems to the Treasury accounts. To assist in auditing FBWT, the DoD is developing an auditable FBWT reconciliation process, including implementation of internal controls, which ensures that reconciling differences are accurate, documented, and resolved in a timely manner. These initiatives must be sustained to enable the DoD to progress towards more accurate financial statements.

## **(6) Financial Statement Compilation**

An effective financial statement compilation process is critical to ensuring that the DoD’s transactions are accurately summarized and reported on its financial statements. The DoD OIG reviews the Agency-Wide compilation process to ensure that all of the Component’s financial statements are completely and accurately consolidated into the DoD Agency-Wide Basic Financial Statements. Additionally, auditors compare the footnotes to the financial statements to determine if the notes and balances reconcile.

Auditors issued over 40 NFRs related to the financial statement compilation process in FY 2018, and the DoD and most of its Components had a material weakness related to the financial statement compilation process. For example, auditors found that the DoD lacked sufficient processes and internal controls to ensure that complete and accurate Component financial statements, including related note disclosures, were prepared prior to the compilation of the Agency-Wide Basic Financial Report. At least three DoD Component financial statements were not compiled correctly into the Agency-Wide Basic Financial Statements.

Although the DoD is taking steps to improve its compilation process, the DoD needs to document the entire financial statement compilation and reporting process for the financial statements and ensure that it is done in a timely fashion.

However, many of the issues within the financial statement compilation process are the result of flaws in other business processes. For example, weaknesses in the FBWT process results in unsupported adjustments that prevent auditors from concluding on the accuracy and fair presentation of the consolidated DoD FBWT balance. Therefore, as the DoD addresses other material weaknesses, such as FBWT and intragovernmental eliminations, improvements in the financial statement compilation process should also occur.

#### *d) Notification of Findings and Recommendations Database and Corrective Action Plans*

In 2017, the DoD CFO developed a centralized database to track NFRs from the DoD financial statement audits and the corrective action plans to address the NFRs. The database provides financial managers a comprehensive view of NFRs and the overarching issues that affect the DoD's financial management. The NFR database also allows DoD management to assess the status of the corrective action plans.

The FIAR Directorate plans to use the information in the NFR database to prepare its Financial Improvement and Audit Remediation Plan, which will describe the specific actions that the DoD plans to take to address the NFRs, interim milestones for completing these actions, and cost estimates for these actions. In addition, to specifically address NFRs related to IT systems, in April 2018, the DoD CFO established an IT group to report on the status of IT NFRs and associated corrective action plans, identify common IT issues, share solutions, and identify instances where common solutions are needed.

Moreover, the DoD Components are now regularly required to report progress on implementing their corrective actions plans to the FIAR Governance Board and the Secretary of Defense. This oversight of corrective actions plans is critical. In the past, the DoD lacked corrective action plans or estimated completion dates for corrective action plans. DoD leadership needs to continue to improve its oversight and attention to corrective action plans to ensure progress in improving DoD financial statements in FY 2019.

## **E. The Way Forward Towards Improved Financial Management**

### **1. Tone at the Top**

The “tone at the top” is a fundamental component of an effective internal control environment. Beginning with the Secretary of Defense, all levels of DoD leadership have stressed the importance and the impact of the financial statement audits and the need to develop efficient and effective business processes that will lead to accurate financial information and improved DoD operations.

For example, on May 25, 2018, the Secretary of Defense issued a memorandum to all DoD personnel clearly expressing the need for and benefits of sound financial management. Secretary Mattis stated that audits provide an objective assessment of how the DoD fulfills its missions, conducts its programs, issues contracts, mitigates cyber threats to DoD information technology systems, and manages DoD personnel and finances. He further explained his vision for action on the part of each member of the DoD, stating that every person at every level within the DoD is accountable to the American public. He also stated that the DoD is responsible for taking immediate corrective action when a discrepancy is uncovered and for developing a plan of action and associated milestones for the longer term. The DoD must then identify the fundamental, underlying problem and change its processes to prevent its reoccurrence.

Other DoD leaders have similarly expressed support for or initiated actions to promote the importance of improving the DoD financial management processes and systems. For example, during testimony before the Armed Services Committee, the DoD CFO stated, “We don’t have to wait for a clean opinion to see the benefits of the audit. The financial statement audit helps drive enterprise-wide improvements to standardize our business processes and improve the quality of our data.”

The DoD and Component leaders must continue to regularly emphasize and express the importance and priority of sound financial management, the financial statement audit, and the implementation of corrective action plans. They must also to continue to hold accountable other DoD leaders who are ultimately responsible for more accurate financial reporting.

## **2. *FIAR Governance Board***

The DoD established the FIAR Governance Board in 2010 to enhance financial management and audit readiness efforts of the DoD and its Components. The Governance Board is co-chaired by the DoD CFO and the DoD Chief Management Officer. It includes the Military Departments Chief Management Officers, DoD financial management senior leaders, and senior representatives from the functional communities. The FIAR Governance Board meets every two months to review financial reporting and financial systems material weaknesses. The Board also monitors the progress of NFR corrective action plans.

Under the FIAR Governance Board, OUSD(C) has established functional councils that meet with Component financial managers and relevant functional area managers. These meetings are used to discuss Agency-Wide issues and ensure a consistent approach to similar NFRs. For example, at the first meeting after the release of the FY 2018 financial statement opinions, the FIAR Directorate presented the common material weaknesses among the DoD Components. Component representatives discussed their audit results and priorities for the FY 2019 financial statement audits. In addition, the Component representatives shared information about their corrective action plans.

The Board should continue to focus on corrective action plans that address the causes of weaknesses and inefficiencies within the DoD's business process. The DoD Components must also test the effectiveness of the plans and share results in this forum. In addition, the Board should continue to use the forum as a tool for collaboration across the DoD. The collaboration should include discussion of lessons learned from the audit, implementation of best practices throughout the DoD, and coordination between service providers and their customers. Finally, the Board should also track the progress of the corrective action plans throughout the DoD and its components.

### ***3. Coordination of Reporting Components***

DoD Components regularly use shared services, rely on the business processes and information technology systems of other Components, and work across business processes to establish efficient operations. For example, the Defense Logistics Agency often orders inventory for the Army, Navy, Air Force, and Marine Corps to gain cost savings through bulk purchases. Also, nearly all DoD Components rely on the Defense Information System Agency to provide telecommunication or internet services rather than contracting for those services individually.

Shared services require coordination between the DoD Components to ensure that the Components understand the impact of those shared services on their business and financial management processes. However, auditors found that many DoD Components could not explain their role in the business processes of shared services or how they verified the accuracy of information provided by others for both management and financial reporting purposes. For example, although the Military Services rely on the Defense Logistics Agency to purchase inventory, each Service is responsible for verifying that the Defense Logistics Agency is accounting for the inventory correctly, but not all the Services had a business process to verify that the information obtained by the Defense Logistics Agency was accurate.

The DoD and its Components began taking action to address identified shared services by coordinating at the FIAR Governing Board meetings, developing cross-Component work groups, and sharing business process descriptions. As additional shared services are identified, the DoD needs to ensure that all Components impacted by the shared services are aware of their roles.

## F. Conclusion

As discussed in this report, the audit of the DoD's financial statements is important for many reasons. The audit can provide more clarity on how the DoD uses its resources; identify vulnerabilities of information technology systems; provide feedback regarding the effectiveness of business systems, processes, and controls; ensure allocation of funds to where they are needed; and improve operational decision-making.

However, it is critical that the DoD and its Components fix the weaknesses and deficiencies identified in the audit through the development, implementation, and monitoring of corrective action plans. In addition, the DoD must continue its commitment to the improvement of DoD business processes.

The road to a clean financial statement opinion is a long-term effort. The DoD OIG and its auditors are committed to supporting that effort by providing clear and actionable feedback through the financial statement audits, which can help improve the DoD's operations, save money, and ensure that Congress and the public understand how the DoD's resources are being spent.

## G. Appendix: History of Opinions on DoD Financial Statement Audit

FY	Army GF	Army WCF	Navy GF	Navy WCF	USMC GF <sup>1</sup>	USAF GF	USAF WCF	USACE-CW	MRF	Agency-Wide
1991	Disclaimer									
1992	Disclaimer					Disclaimer			Unqualified	
1993	Disclaimer					Disclaimer			N/A <sup>2</sup>	
1994	Disclaimer					Disclaimer			N/A <sup>2</sup>	
1995	Disclaimer					Disclaimer			Unqualified	
1996	Disclaimer		Disclaimer			Disclaimer		Disclaimer	Unqualified	Disclaimer
1997	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
1998	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
1999	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
2000	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
2001 <sup>3</sup>	N/A	N/A	N/A	N/A		N/A	N/A	N/A	Unqualified	Disclaimer
2002	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
2003	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
2004	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
2005	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Disclaimer	Unqualified	Disclaimer
2006	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Qualified	Unqualified	Disclaimer
2007	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Qualified	Unqualified	Disclaimer
2008	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unqualified	Unqualified	Disclaimer
2009	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unqualified	Unqualified	Disclaimer
2010	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unqualified	Unqualified	Disclaimer
2011	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unqualified	Unqualified	Disclaimer
2012	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unqualified	Unqualified	Disclaimer
2013	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unmodified	Unmodified	Disclaimer

*History of Opinions on DoD Financial Statement Audit (cont'd)*

FY	Army GF	Army WCF	Navy GF	Navy WCF	USMC GF <sup>1</sup>	USAF GF	USAF WCF	USACE-CW	MRF	Agency-Wide
2014	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unmodified	Unmodified	Disclaimer
2015	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unmodified	Unmodified	Disclaimer
2016	Disclaimer	Disclaimer	Disclaimer	Disclaimer		Disclaimer	Disclaimer	Unmodified	Unmodified	Disclaimer
2017	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Unmodified	Unmodified	Disclaimer
2018	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Disclaimer	Unmodified	Unmodified	Disclaimer

<sup>1</sup> USMC GF was consolidated with the Navy GF until FY 2017 and reported at the Department of the Navy GF. Beginning in FY 2017, the USMC began preparing full financial statements for audit.

<sup>2</sup> The FY 1993 and FY 1994 Military Retirement Fund financial statements were not audited.

<sup>3</sup> DoD Components, except for the Military Retirement Fund, did not submit financial statements for audit for FY 2001. Therefore, no audit opinions were issued for that fiscal year.



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