Audit Report

OFFICE OF THE INSPECTOR GENERAL

VOLUNTARY SEPARATION INCENTIVE TRUST FUND FINANCIAL STATEMENTS FOR FY 1994

Report No. 95-158

March 29, 1995

Department of Defense

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Acronyms

DFAS	Defense Finance and Accounting Service
GAO	General Accounting Office
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
VSI	Voluntary Separation Incentive

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MEMORANDUM FOR SECRETARY OF DEFENSE
UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER OF THE
DEPARTMENT OF DEFENSE
UNDER SECRETARY OF DEFENSE FOR PERSONNEL
AND READINESS

SUBJECT: Audit Opinion on the Voluntary Separation Incentive Trust Fund Financial Statements for FY 1994 (Project No. 4FI-2013)

Introduction

We are providing this report for your information and use and for use by the Congress. Financial statement audits are required by the Chief Financial Officers Act of 1990. Office of Management and Budget (OMB) Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, requires the Inspector General, DoD, to express an opinion on financial statements and report on the adequacy of internal controls and compliance with laws and regulations. This report contains our opinion on the Voluntary Separation Incentive Trust Fund (the Fund) Financial Statements for FY 1994.

Audit Opinion

In Inspector General, DoD, Report No. 94-166, "Voluntary Separation Incentive Trust Fund Financial Statements for FY 1993," June 30, 1994, we expressed an opinion that the FY 1993 financial statements did not fairly present the financial position, results of operations, cash flows, or budget and actual expenses of the Fund because accrued liabilities and accrued expenditures were not accurately reported. As described in Note 1 of the FY 1994 financial statements, the Defense Finance and Accounting Service (DFAS) has changed its method of accounting for those items and restated its FY 1993 financial statements to conform with generally accepted accounting principles applicable to DoD financial statements. Accordingly, our present opinion on the FY 1993 financial statements is different from that expressed in our previous report.

In our opinion, the FY 1994 financial statements present fairly, in all material respects, the financial position of the Fund as of September 30, 1994, and September 30, 1993, and the results of operations, cash flows, and budget and actual expenses for the years then ended, in accordance with DoD accounting policies and procedures and generally accepted accounting principles applicable to DoD financial statements.

Audit Objectives

The primary audit objective was to determine whether the Fund's FY 1994 financial statements were presented fairly in accordance with generally accepted accounting principles or the other comprehensive basis of accounting described in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. We evaluated the internal control structure established for the Fund, and we assessed compliance with applicable laws and regulations that could have a material effect on the financial statements. We followed up on the conditions noted in our audit of the Fund's FY 1993 financial statements. In an advisory memorandum we issued on October 14, 1994, to the Under Secretary of Defense for Personnel and Readiness, we identified improvements to the financial statement process. Those improvements could provide beneficial data to program managers and other users of financial statements.

Scope and Methodology

We examined the financial statements of the Fund for the years ended September 30, 1994, and September 30, 1993. The statements included the Overview and Notes to the four Principal Statements: Statement of Financial Position, Statement of Operations (and Changes in Net Position), Statement of Cash Flows, and Statement of Budget and Actual Expenses. Our opinion is based on statements provided to us on March 3, 1995, by the Deputy Chief Financial Officer of the Department of Defense.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, including the accompanying overview and notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements.

Scope of the Review of Internal Controls. We updated our FY 1993 client profile for the Fund and the memorandums on the contribution, Treasury, expenditure, and financial reporting cycles. Those memorandums assessed the internal control structure. We believe that our audit provides a reasonable basis for our opinion. This financial statement audit was made during the period June 1994 through February 1995.

Scope of the Review of Compliance With Laws and Regulations. To obtain reasonable assurance about whether the Principal Statements are free of material misstatements, we tested compliance with laws and regulations that may directly affect the financial statements, and other laws and regulations designated by the OMB and DoD for inclusion in financial statement audits. We identified the key provisions of those laws and regulations, and we reviewed transactions, documents, and other records to ensure that they complied with the provisions of those laws and regulations.

Reliability of Computer-Processed Data. We performed various reviews to determine the reliability of computer-processed data provided to us. We limited

our review of general and application controls for computer-processed data to tracing transactions through the Trust Funds Accounting System, observing operations, conducting interviews, and verifying securities balances on U.S. Treasury reports. We performed limited reviews of the other systems that generated the payment and accounting data we used. We also reviewed the financial information in management's Overview of the Fund. To the extent that we reviewed the data, we concluded that the data were sufficiently reliable to meet our audit objectives.

Use of an Independent Actuary. For this audit, we did not use an independent actuary to review and assess the actuarial methods, policies, and procedures used by the Office of the Actuary, DoD (the DoD Actuary). In FY 1993, the Chief Actuary of the General Accounting Office (the GAO Actuary) assisted the Office of the Assistant Inspector General for Auditing, DoD, by performing an independent review of the financial information prepared by the DoD Actuary. The GAO Actuary limited his review to assessing the DoD Actuary methods, policies, and procedures of estimating the present value of accumulated plan benefits as shown on the financial statements. The GAO Actuary determined that the present value of accumulated plan benefits was formulated in accordance with generally accepted actuarial principles, and that the actuarial present value of accumulated plan benefits was reasonable.

Our review of the actuarial methods, policies, and principles used by the DoD Actuary would not necessarily disclose all reportable conditions or weaknesses. However, for FY 1994, neither the economic assumptions used to calculate the "present value of accumulated plan benefits" nor the Actuary's computer program for calculating future benefits changed. We determined that the methods, policies, and principles had not changed from the preceding year, and there is reasonable assurance that the financial information is accurate.

Auditing Standards

We conducted our audit in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD, and OMB Bulletin No. 93-06, January 8, 1993, and the general provisions of the President's Council on Integrity and Efficiency, "Federal Financial Statement Audit Manual," January 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Statements are free of material misstatements. To assess the materiality of matters that affect the fair presentation of the financial statements and related internal control weaknesses, we relied on the guidelines suggested by GAO and our professional judgment.

Accounting Principles

Accounting principles for use in preparation of financial statements required by the Chief Financial Officers Act of 1990 remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, OMB; the Secretary of the

Treasury; and the Comptroller General of the United States. Those officials are the principals of the Joint Financial Management Improvement Program (JFMIP). The Director, OMB, and the Comptroller General of the United States issue specific standards agreed on by the JFMIP principals.

The Director, OMB, and the Comptroller General of the United States have not issued accounting principles that will govern all aspects of financial statement reporting and that will constitute "generally accepted accounting principles for the Federal Government." Until those principles are issued, agencies are required to follow the hierarchy of accounting principles described in OMB Bulletin No. 94-01. The hierarchy constitutes the "other comprehensive basis of accounting" to be used for preparing the financial statements of Federal agencies. A summary of the hierarchy defined and approved by the JFMIP principals follows:

- o statements agreed to and published by the JFMIP principals,
- o form and content requirements of the OMB,
- o accounting principles in agency guidance, and
- o accounting principles published by other authoritative sources.

To date, three accounting principles have been published by the JFMIP principals, so most accounting principles for the DoD "other comprehensive basis of accounting" are found in DoD accounting policy guidance. The DoD accounting guidance is primarily in the DoD Accounting Manual. The Office of the Under Secretary of Defense (Comptroller) has updated portions of the DoD Accounting Manual and has incorporated those sections into DoD 7000.14-R, "DoD Financial Management Regulation," (DoD Financial Regulation).

The DoD Financial Regulation will eventually serve as the single DoD-wide financial management regulation for use by all DoD Components for accounting, budgeting, finance, and financial management education and training. In the interim, unless superseded by published Federal accounting principles or requirements of OMB, the policy in the DoD Accounting Manual or in the DoD Financial Regulation, as applicable, is the authoritative basis for preparing financial statements in accordance with the "other comprehensive basis of accounting."

Prior Audits and Other Reviews

The Inspector General, DoD, issued Report No. 94-166, "Voluntary Separation Incentive Trust Fund Financial Statements for FY 1993," on June 30, 1994. In that report, we expressed an adverse opinion on the Fund's financial statements for FY 1993 because the statements did not present fairly the financial position, the results of operations, cash flows, or budget and actual expenses of the Voluntary Separation Incentive Trust Fund. The statements materially misstated Accrued Entitlement Benefits in the Statement of Financial Position and

Program or Operating Expenses in the Statement of Operations. Also, the statements incorrectly reported Accounts Receivable, Net - Non-Federal at a zero amount. Those misstatements also affected similar line items in the Statement of Cash Flows and the Statement of Budget and Actual Expenses.

Background

The Fund was established on January 1, 1993, in 10 U.S.C. 1175, "Voluntary Separation Incentive," as added by Public Law 102-190, "National Defense Authorization Act for Fiscal Years 1992 and 1993." The purpose of the Fund was to accumulate funds to finance, on an actuarially sound basis, liabilities of DoD under the Voluntary Separation Incentive (VSI) program. The VSI program was one of two programs authorized by Public Law 102-190 to encourage military members with more than 6 years but fewer than 20 years of service to separate from active duty. Public Law 102-484, "National Defense Authorization Act for Fiscal Year 1993," October 23, 1993, and Public Law 103-160, "National Defense Authorization Act for Fiscal Year 1994," November 30, 1993, amended 10 U.S.C. 1175. Public Law 102-484 authorized a third voluntary separation program to members who had previously separated under the VSI program. Public Law 103-160 authorized an extension of the VSI program from FYs 1995 to 1999. Members who separate under the VSI program are to receive annual payments for a period of time equal to twice the number of years of creditable service they have at the time of separation. Through September 30, 1994, approximately 14,100 members separated from the Services (the Army, the Navy, the Air Force, and the Marine Corps) under the VSI program.

As of September 30, 1994, the Fund's assets were $821.4 million and its unfunded liabilities were $620.5 million. The Services did not contribute to the Fund during FY 1994. The Fund received $40.7 million in interest earned on nonmarketable U.S. Treasury securities. The Under Secretary of Defense for Personnel and Readiness is the fund manager. The Principal Statements of the Fund are the responsibility of the Under Secretary of Defense for Personnel and Readiness and the Director, DFAS.

Discussion

Internal Controls. We reviewed the internal control structure of the Fund and obtained an understanding of the internal control policies and procedures. We also assessed the level of control risks relevant to all significant cycles, classes of transactions, and account balances. For the significant control policies and procedures that had been properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed.

We did not identify internal control weaknesses that we considered to be material or reportable conditions under standards established by OMB Bulletin No. 93-06. The material internal control weaknesses we identified in the FY 1993 financial statement audit were included in the FY 1994 Annual

Statement of Assurance of DFAS, and were reported to the Under Secretary of Defense (Comptroller) as required by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. We followed up on those internal control weaknesses and determined that the Under Secretary of Defense for Personnel and Readiness and the Director, DFAS, had implemented reasonable corrective actions. We did not identify any additional internal control weaknesses that we considered to be material and reportable.

Compliance With Laws and Regulations. We evaluated the Fund for material instances of noncompliance with laws and regulations for the fiscal year ended September 30, 1994. Such tests are required by the Chief Financial Officers Act of 1990.

Fund operations generally complied with applicable laws and regulations. One exception was that the Services did not fully comply with 10 U.S.C. 1175. The Services did not compute the years of military service creditable to separated members in compliance with 10 U.S.C. 1405, "General Military Law," Subtitle A, "Computation of Retired Pay." In addition, documentation was not available in personnel records to substantiate that all members had established the required Reserve affiliation. However, we concluded that the procedural changes made by the Services and the Office of the Under Secretary of Defense for Personnel and Readiness should ensure compliance in the future. The problems did not materially affect the financial statements. We also determined that the financial management systems used to collect and report information on the VSI program did not capture liabilities and expenditures on an accrual basis as required by OMB Circular No. A-127, "Financial Management Systems," July 23, 1993. By improving the manual procedures for reporting the liabilities and expenditures of the Fund, DFAS reduced the significance of the weaknesses in the financial management systems.

We appreciate the courtesies shown to the audit staff. If you have questions about this audit, please contact Mr. Richard B. Bird, Audit Program Director, at (317) 542-3859 (DSN 699-3859) or Mr. Carmelo G. Ventimiglia, Audit Project Manager, at (317) 542-3852 (DSN 699-3852). The distribution of this report is in the enclosure. Audit team members are listed inside the back cover.

David Steensma

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