Audit Report

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR FY 1997 NATIONAL DEFENSE STOCKPILE TRANSACTION FUND FINANCIAL STATEMENTS

Report Number 98-166

June 25, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CFO	Chief Financial Officers
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DNSC	Defense National Stockpile Center
FFMIA	Federal Financial Management Improvement Act of 1996
GSA	General Services Administration
IG	Inspector General
JFMIP	Joint Financial Management Improvement Program
MIF	Master Inventory File
OMB	Office of Management and Budget
SFFAS	Statement of Federal Financial Accounting Standards
USGSGL	U.S. Government Standard General Ledger

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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June 25, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
DIRECTOR, DEFENSE LOGISTICS AGENCY
ADMINISTRATOR, DEFENSE NATIONAL STOCKPILE CENTER

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the FY 1997 National Defense Stockpile Transaction Fund Financial Statements (Report No. 98-166)

We are providing this report for review and comments. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspector General. Our responsibility is to issue an opinion on the financial statements. On February 27, 1998, we issued a disclaimer of opinion on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements. Our disclaimer of opinion and the financial statements are in Appendix C of this report. We identified internal control weaknesses and instances of noncompliance with laws and regulations that merit management attention.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense (Comptroller) and the Defense Finance and Accounting Service did not comment on the draft report. We request comments from those offices. The Defense Logistics Agency comments were partially responsive and were considered when preparing the final report. We request additional comments from the Defense Logistics Agency on Recommendations D.3. and F. 2. Management comments should indicate concurrence or nonconcurrence with each applicable finding and recommendation. Comments should describe actions taken or planned in response to agreed-upon recommendations and provide the completion dates of the actions. State specific reasons for any nonconcurrence and propose alternative actions, if appropriate. We request all additional comments by August 25, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent at (703) 604-9110, e-mail dvincent@dodig.osd.mil, or Mr. John A. Richards at (703) 604-9133, e-mail jrichards@dodig.osd.mil. See Appendix F for the report distribution. The audit team members are listed inside the back cover.

Robert J. Lieberman
Assistant Inspector General
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Office of the Inspector General, DoD

Report No. 98-166 **June 25, 1998**

Project No. 8FH-2004.01

Internal Controls and Compliance With Laws and Regulations for the FY 1997 National Defense Stockpile Transaction Fund Financial Statements

Executive Summary

Introduction. This audit was performed pursuant to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The Defense National Stockpile Center serves as the national repository for raw materials that are critical to Defense industries in the event of a national emergency. In FY 1997, $4.1 billion of assets and $120 million of liabilities were reported for the National Defense Stockpile Transaction Fund. Revenues from sales of stockpile assets were reported at $529.4 million. The Program Manager responsible for this fund is the Director, Defense Logistics Agency.

Audit Objectives. The overall audit objective was to determine whether the FY 1997 National Defense Stockpile Transaction Fund Financial Statements were presented fairly and in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. In addition, we assessed internal controls and compliance with laws and regulations and followed up on corrective actions from previous reports. Our review provided a reasonable basis for determining the adequacy of the internal controls and compliance with laws and regulations as they relate to the financial statements.

Disclaimer of Opinion. We were unable to render an opinion on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements because we could not verify the inventory valuation and confirm the accounts receivable. We were unable to verify the inventory valuation because the results of bulk commodities measurements by the Army Corps of Engineers were not available by the date the opinion was issued. Lacking the data on bulk commodities, we were unable to evaluate and project the results of the entire sample of materials and could not determine whether the on-hand quantities of materials (80 percent of total assets) were accurate. In addition, we were unable to confirm the accuracy of accounts receivable (7 percent of the total assets). We attempted to confirm the accounts receivable balances as of September 30, 1997. We received responses from only 60 percent of the customers, and 42 percent of these responses showed differences between the Government's and customers' balances.

Internal Controls. Internal controls were generally effective in accounting for and managing resources, ensuring compliance with laws and regulations, and providing reasonable assurance that the financial statements were free of material misstatements. None of the accounts affected by internal control weaknesses addressed in this report resulted in a known material misstatement in the financial statements. However, the

material weakness we identified in the reporting of accounts receivable (Finding B) had the potential to cause a material misstatement. We could not determine the extent of any actual misstatement because of the low response for accounts receivable.

Management attention is required to collect $33.4 million in delinquent accounts receivable (Finding A); to ensure the accuracy of the entire $281.2 million reported for Accounts Receivable and Interest Receivable (Finding B); and to reconcile accounts with the U.S. Mint for silver used in commemorative coins (Finding C). See Part I.A. for the internal control weaknesses identified and Appendix A for the internal controls assessed.

Compliance With Laws and Regulations. Management generally complied with selected provisions of laws and regulations on the accuracy of the financial statements. However, the Defense National Stockpile Center did not comply with Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," October 27, 1993, for stockpile inventory that has declined in value (Finding D). In addition, the Defense National Stockpile Center inappropriately retained funds received for the sale of certain commodities under Public Law 104-201, "National Defense Authorization Act for Fiscal Year 1997," September 23, 1996 (Finding E). The financial statements did not fully comply with Dod Regulation 7000.14-R, the "DoD Financial Management Regulation," volume 6, chapter 6, "Form and Content of Audited Financial Statements," January 1998 (Finding F). A compliance issue, the failure to recognize pension costs as a liability on the financial statements, was also identified in our audit report on the National Defense Stockpile Transaction Fund Financial Statements for FY 1996 (see Part I.B. for the compliance issues we identified).

Finally, the financial management systems did not comply with Federal requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. With respect to items not tested, we found nothing that caused us to believe that management had not complied in all material respects with the provisions previously identified.

Summary of Recommendations. We recommend that the Director, Defense Finance and Accounting Service Columbus Center, assume responsibility for collecting of all accounts receivable. We recommend that the Administrator, Defense National Stockpile Center, and that the Director, Defense Finance and Accounting Service Columbus Center, promptly reverse accounts receivable on closed contracts and promptly post collections to Accounts Receivable. We also recommend that the Administrator, Defense National Stockpile Center, request written statements from the U.S. Mint on the total amount of silver in the Stockpile; recognize inventory losses; and prepare the FY 1998 Financial Statements in compliance with laws and regulations. Finally, we recommend that the Under Secretary of Defense (Comptroller) promptly transfer funds from the sale of certain stockpile commodities to the General Fund of the U.S. Treasury.

Management Comments. The Director, Defense Logistics Agency, concurred with most of the recommendations, stating that the Defense National Stockpile Center would establish procedures for clearing completed contracts, request information about silver from the U.S. Mint, and take various steps to improve inventory valuation and financial statement compliance. The Defense Logistics Agency nonconcurred with our recommendation to change procedures to set a dollar threshold for the investigation and write-off of identified inventory shortages. The Defense Logistics Agency stated that it was more cost effective to perform computed counts rather than actual counts. In addition, a fixed percentage of quantity is the only measurement that is not affected by the variables of acquisition value or market value. The Defense Logistics Agency concurred with the intent of our recommendation to accrue future environmental cleanup costs as a contingent liability. The Defense Logistics Agency does not agree that the amount of environmental cleanup is a contingent liability. The Defense Logistics Agency agrees that there will be future operating costs and plans to use the Treasury General Ledger Account, Accrued Cleanup Costs, to record estimated future outlays. See Part I for a discussion of the management comments and Part III for the text of the comments.

Audit Response. We consider the comments from the Director, Defense Logistics Agency, to be partially responsive. We agree that computed counts are the only practical method of counting many commodities, and that computed commodities are not exact. However, we found cases where commodities were in such condition that a carefully computed count could have been off by a large amount that would result in an inaccurate adjustment being made to the inventory records. Further, some commodities have consistently shown shortages over a period of years. Therefore, for these commodities adjustments to inventory records should have been accomplished to meet the Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," October 27, 1993 requirements. In addition, Standard No. 3 requires the relevant dollar value, which should be the lower of the acquisition cost or market value. Therefore, the dollar value on the financial statements must be a factor in determining whether to adjust the identified physical shortages.

The environmental cleanup costs incurred by the Defense National Stockpile Center for commodities stored do not meet the requirements of the Accrued Cleanup Costs account. This particular account was established for the cleanup cost associated with the "removing, containing, and/or disposing of hazardous materials associated with the current portion of general or stewardship property, plant, and equipment operation." Since the estimated cost of future environmental cleanup does not meet the definition of Accrued Cleanup Cost but does meet the definition for contingent liabilities, we believe the contingent liability should be shown on the financial statements in accordance with the Form and Content of Agency Financial Statement requirements.

We did not receive comments from the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service. We request comments on the final report from the Under Secretary of Defense (Comptroller); the Director, Defense Finance and Accounting Service; and additional comments from the Director, Defense Logistics Agency, by August 25, 1998.

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Part I - Audit Results

Audit Background

Introduction. The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of revolving funds such as the National Defense Stockpile Transaction Fund (the Fund). Our responsibility under the CFO Act is to render an opinion on the financial statements based on our audit, and to determine whether internal controls were adequate and whether management complied with applicable laws and regulations. The Defense Logistics Agency (DLA) and the Defense Finance and Accounting Service (DFAS) are jointly responsible for the information in the National Defense Stockpile Transaction Fund Financial Statements for FYs 1997 and 1996. The Defense National Stockpile Center (DNSC) serves as the national repository for raw materials that are critical to Defense industries in the event of a national emergency. In FY 1997, $4.1 billion of assets and $120 million of liabilities were reported for the National Defense Stockpile Transaction Fund. Revenues from the sales of assets were reported at $529.4 million.

Accounting Policies. The Consolidated Financial Statements of the National Defense Stockpile Transaction Fund (the Fund) for FYs 1997 and 1996 were to be prepared in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, November 16, 1993, as amended by OMB Bulletin No. 97-01, October 16, 1996. These bulletins incorporate the concepts and standards in the Statements of Federal Accounting Concepts and Standards recommended by the Federal Accounting Standards Board, which are approved by the Secretary of the Treasury; the Director, OMB; and the Comptroller General of the United States. Footnote 1 of the FY 1997 National Defense Stockpile Transaction Fund Financial Statements discusses the significant accounting policies used to prepare the financial statements.

Disclaimer of Opinion. We were unable to render an opinion on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements because we could not verify the inventory valuation and confirm the accounts receivable. We were unable to verify the inventory valuation because the results of bulk commodities measurements by the Army Corps of Engineers (the Corps) were not available by the date the opinion was issued. The Corps results were late because of difficulties with selecting the statistical sample and scheduling visits to sample sites by Corps personnel, subcontractors, and auditors, and because the opinion for this fiscal year was required to be issued earlier than in previous years.

Because of the lack of data on bulk commodities, which account for approximately 39 percent of DNSC materials, we were unable to evaluate and project the results of the entire sample of DNSC materials. Therefore, we could not determine whether the on-hand quantities of Stockpile Materials (80 percent of total assets) were accurate. In addition, we were unable to confirm the accuracy of the Accounts Receivable (7 percent of total assets). We attempted to confirm Accounts Receivable as of September 30, 1997. However, we received responses from only 60 percent of the customers, and 42 percent of the responses showed differences between the Government's and customers' balances. See Appendix C for the Principal Statements and Audit Opinion.

Audit Objectives

The overall audit objective was to determine whether the FY 1997 National Defense Stockpile Transaction Fund Financial Statements were presented fairly and in accordance with OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01. In addition, we assessed internal controls and compliance with laws and regulations and followed up on corrective actions from previous reports. Our review provided a reasonable basis for determining the adequacy of the internal controls and compliance with laws and regulations as they related to the financial statements. Part I.A. is our report on internal controls. Part I.B. is our report on compliance with laws and regulations. Appendix A discusses the scope, methodology, auditing standards, accounting principles, and management control program. Appendix B provides a summary of prior audit coverage.

Part I. A. - Review of Internal Controls

Introduction

Audit Responsibilities. The audit objective was to determine whether management controls over transactions supporting the accounts in the FY 1997 National Defense Stockpile Transaction Fund Financial Statements were adequate to ensure that the accounts were free of material error. In planning and performing our audit, we evaluated certain aspects of the internal controls established for the Fund. We performed this evaluation to:

- determine the auditing procedures necessary to render an opinion on the financial statements; and

- determine whether internal controls had been established.

Management Responsibilities. DLA management was responsible for establishing and maintaining internal controls over the Fund. This responsibility requires management to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control structure is to provide management with reasonable but not absolute assurance that:

- transactions are properly recorded and accounted for in order to prepare reliable financial statements and maintain accountability over assets;

- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and

- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and are in compliance with other laws and regulations that the OMB, the entity management, or the Inspector General, DoD, have identified as being significant and for which compliance can be objectively measured and evaluated.

Internal Control Elements. DoD Directive 5010.38, "Management Control Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996, implement title 31, United States Code, section 3512 (31 U.S.C. 3512), which requires management to establish and maintain a comprehensive management control system that includes internal controls and to monitor and report on the system. The internal control structure consists of three elements.

- The control environment is the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management's philosophy and operating style, the entity's organizational structure, and personnel policies and practices. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of controls and the emphasis placed on them by the entity.

- Accounting and related systems are the methods and records established to identify, assemble, analyze, classify, record, and report on the entity's transactions and maintain accountability for the related assets and liabilities.

- Control procedures are the policies and procedures, in addition to the control environment and accounting and related systems, that management has established to provide reasonable assurance that specific objectives will be achieved.

Reportable Conditions

Our audit disclosed reportable conditions and a material internal control weakness under OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, as modified by OMB Bulletin No. 98-04, "Implementation Guidance for the Federal Managers' Financial Integrity Act of 1996," January 16, 1998. OMB Bulletin No. 98-04 was effective for the FY 1997 financial statements. OMB issued a memorandum dated September 9, 1997, providing interim implementation guidance for preparing the FY 1997 financial statements. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal controls does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited, and would not be detected in a timely manner by employees in the normal course of performing their functions.

Our consideration of internal controls would not necessarily disclose all reportable conditions, and would not necessarily disclose all reportable conditions that are considered to be material weaknesses. See Appendix A for a discussion of the internal controls assessed.

Reportable conditions addressed in last year's report continue to exist. Specifically, management needs to improve the collection of accounts receivable (Finding A). In addition, a reportable condition exists in accounting for silver with the U.S. Mint (Finding C). A material internal control weakness exists in the reporting of accounts receivable (Finding B). As a result of the material weakness, we could not confirm the accounts receivable. This was a major reason for our disclaimer of opinion on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements.

Finding A. Collection of Accounts Receivable

Delinquent accounts and interest receivable of the Fund increased from $15.5 million reported on September 30, 1996, to $33.4 million on September 30, 1997. Of the $15.5 million reported on September 30, 1996, $10.7 million was still due on September 30, 1997. Previous audit reports identified the same condition and recommended improvements in the collection and write off of accounts receivable. The collection of accounts receivable did not improve because DNSC did not finalize a new Concept of Operations between DNSC and the DFAS Columbus Center until late January 1998. Furthermore, DNSC and the DFAS Columbus Center did not develop procedures for improving collections and writing off accounts receivable until February 1998. The amount of receivables increased because of the lack of action by DNSC and the DFAS Columbus Center. Consequently, amounts legitimately due to DoD may become uncollectible and never recovered.

Recommendations in Prior Audit Reports

Our reports on internal controls for FYs 1995 and 1996 recommended that DNSC and the DFAS Columbus Center improve the collection and write-off of accounts receivable. Specifically, our FY 1996 report, Report No. 97-176, "Internal Controls and Compliance With Laws and Regulations for the National Defense Stockpile Transaction Fund Financial Statements for FY 1996," June 25, 1997, recommended that DNSC and the DFAS Columbus Center revise their joint Concept of Operations to transfer responsibility for pursuing delinquent receivables to the DFAS Columbus Center. We also recommended that DNSC and the DFAS Columbus Center develop and adhere to a schedule for collecting and writing off the receivables. DLA concurred with both recommendations and estimated that corrective action would be complete by July 31, 1997. DFAS also concurred with both recommendations and gave an estimated completion date of August 29, 1997, for all corrective actions. In its second response dated November 24, 1997, DFAS changed the estimated completion date to November 28, 1997. This response also stated that DNSC and the DFAS Columbus Center had agreed to divide the responsibility for the accounts receivable. DNSC would be responsible for all accounts receivable created before October 1, 1997, and the DFAS Columbus Center would be responsible for accounts receivable created after October 1, 1997. This agreement regarding old and new accounts receivable was not reflected in the subsequent Concept of Operations, and did not meet the intent of our recommendations.

IG, DoD, Report No. 97-176 also recommended that the DFAS Columbus Center research and actively pursue the collection of delinquent accounts receivable as of September 30, 1996, regardless of the date created; write off receivables determined to be uncollectible; and refer receivables of more than

$600, and not considered uncollectible, to the DFAS Columbus Center's Debt Management Office. The first response from the DFAS Columbus Center concurred with all recommendations and gave an estimated completion date of October 31, 1997, subject to revision of the Concept of Operations and receipt of the necessary records from DNSC. The second response specified the same conditions and revised the estimated completion date to November 28, 1997.

Concept of Operations

DNSC and the DFAS Columbus Center did not complete their revision of the Concept of Operations until late January 1998. The delay occurred because DNSC and the DFAS Columbus Center management did not place sufficient emphasis on its completion. The Concept of Operations covers accounts receivable and many other aspects of the interaction between DNSC and the DFAS Columbus Center. It makes the DFAS Columbus Center responsible for handling all delinquent accounts; DNSC is responsible only for providing information and coordinating inquiries and resolution. The Concept of Operations states that the DFAS Columbus Center should adhere to DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume 4, chapter 3, "Receivables," January 1995. DNSC is not responsible for receivables arising before October 1, 1997. However, DNSC and the DFAS Columbus Center have both confirmed that DNSC is responsible for receivables created before October 1, 1997, as stated in the second DFAS response to IG, DoD, Report No. 97-176.

Overall Progress on Collections

The division of responsibility between DNSC and the DFAS Columbus Center for receivables was contrary to the previously agreed-upon recommendation that the DFAS Columbus Center take full responsibility. The results showed that the agreement, which was not part of the Concept of Operations, was unsatisfactory. Neither organization took action before February 1998, when key employees of DNSC and the DFAS Columbus Center met at the DFAS Columbus Center to develop procedures for implementing the new Concept of Operations. As of January 31, 1998, the delinquent receivables had been reduced to $26.1 million, compared to $33.4 million as of September 30, 1997. However, this was still significantly more than the $15.5 million in delinquent receivables as of September 30, 1996. We had expected that the delinquent receivables would be significantly reduced from the September 30, 1996, level. The DoD Financial Management Regulation gives specific guidance for handling delinquent receivables; DNSC and the DFAS Columbus Center should not have waited until the Concept of Operations was finalized in order to take action on the receivables.

Referrals to Debt Management Office

DNSC referred its first receivables to the Debt Management Office in March 1998; those receivables should have been referred earlier. IG, DoD, Report No. 97-176 discussed unsuccessful efforts to refer to the Debt Management Office about $2.8 million in delinquent receivables for diamond contracts. On March 6, 1998, DNSC referred these debts to the Debt Management Office. The DoD Financial Management Regulation, volume 10, chapter 18, "Contractor Debt Collection," February 1996, requires that any debt of $600 or greater that has not been resolved after two collection letters must be transferred to the Debt Management Office. Public Law 104-304, the "Debt Collection Improvement Act of 1996," April 25, 1996, requires nontax debts delinquent for 180 days to be transferred to the Department of the Treasury. At the discretion of the Secretary of the Treasury, the referral may be to a debt collection center of an Executive department or agency. DNSC took excessive time to refer these receivables. Also, numerous other debts of $600 or more were not referred to the Debt Management Office.

Closed Contracts Cited in 1995 Audit Report

Our FY 1995 report identified 21 closed contracts with outstanding accounts receivable valued at $206,366. Only one of these, a minor item valued at $1,489, is no longer outstanding. The total of the 20 remaining contracts has increased by $108,051 to $312,928. Fifteen of the 20 contracts, valued at $242,467, belong to a contractor who has had a claim of over $202,000 against the Government since 1993. DNSC has attempted to resolve this claim since we confirmed the accounts receivable with the client; however, the claim should not have been unresolved since 1993. Two other contracts, valued at $61,530, are among the diamond contracts that have been referred to the Debt Management Office, as previously discussed. No action has been taken on the remaining three contracts, valued at $8,931.

Conclusion

Collectible amounts legitimately due to DoD will become uncollectible if delinquent collections are not pursued and debts are not referred to the Debt Management Office. Additionally, the accounts receivable in the financial statements were overstated; as a result of the lack of followup on receivables, some amounts that are not legitimately due continue to be recorded as receivables. See Finding B for a complete discussion of followup issues.

Management Comments on the Finding and Audit Response

Management Comments on Collection of Accounts Receivable. DLA partially concurred with the finding, stating that the increase in delinquent receivables was caused by untimely contract administration, resulting from a substantial increase in the contracting workload during FY 1997. DLA management did not agree that the delay in finalizing the Concept of Operations had a negative effect on contract administration and therefore on the status of accounts receivable. DLA stated that DNSC management is evaluating the recommendations from the February 1998 visit to the DFAS Columbus Center to improve contract administration procedures. DLA also stated that implementing these procedures should reduce the inaccurate accounts receivable balances discussed in Finding B of this report. DLA believes that transferring collection responsibility for the older receivables to DFAS Columbus Center would be effective, but only after DLA improves the accuracy of the receivable balances.

Audit Response. We believe that transferring the collection responsibility to the DFAS Columbus Center is the most effective way to expedite improvements in collections. In response to our FY 1995 report, DNSC did not improve the accuracy of the receivable balances during FY 1996, when the contracting workload was lower. We recommended the transfer of collection responsibility in our FY 1996 report, in order to encourage the resolution of delinquent balances as a result of DFAS collection procedures. Any problems caused by DFAS pursuing inaccurate receivables could be resolved. In response to the FY 1996 report, DNSC did not send the team to the DFAS Columbus Center until February 1998, after finalization of the Concept of Operations, and as of May 1998, no improved contract administration procedures had been implemented. As stated earlier, the level of delinquent receivables, instead of declining, has increased significantly. Therefore, we have not changed our recommendations to DFAS.

Recommendations for Corrective Action

A. We recommend that the Director, Defense Finance and Accounting Service Columbus Center:

1. Assume responsibility for all accounts receivable and related interest collections, including those amounts that became due before October 1, 1997.

2. Pursue the collection of the receivables, refer appropriate receivables to the Debt Management Office, and write off accounts receivable as appropriate.

Management Comments Required

The Director, DFAS, did not comment on a draft of this report. We request that the Director, DFAS, provide comments on the final report.

Finding B. Reporting of Accounts Receivable

The $281.2 million in Accounts Receivable and Interest Receivable reported on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements was overstated by approximately $9.7 million. This occurred because charges that should have been reversed by September 30, 1997, were not reversed, and cash received had not been posted as of September 30, 1997. Therefore, Accounts Receivable and the Net Position of the Fund were overstated by approximately $2.6 million in receivables that should have been reversed. In addition, Accounts Receivable were overstated by $7.1 million for cash received but not posted; Fund Balance with Treasury was understated by the same amount; and there was increased potential for problems in determining the amounts owed by contractors.

Confirming Accounts Receivable

As part of our audit of the FY 1997 Fund Financial Statements, we requested confirmation from 55 contractors, representing 97 percent of the dollar value of receivables. We received responses from 60 percent of the contractors to whom we sent requests for confirmation. Of those who responded, 42 percent did not agree with the DNSC figures. In most cases where contractors disagreed, the contractors were found to be correct; DNSC continues to research the other cases. The balances confirmed as incorrect total $9.2 million, and the receivables being researched total $.5 million. Of the $9.2 million, $2.1 million represented receivables that should have been reversed as of September 30, 1997; if the contractors are correct, the $.5 million being researched will also need to be reversed. The amounts were not reversed because DNSC did not follow up to ensure that $2.3 million remaining on completed contracts was removed from accounts receivable and that $.3 million in related interest and storage charges was reversed. The other $7.1 million of the $9.2 million represented cash that had been received as of September 30, 1997, but not posted. The cash collections were not posted because of delays in the posting process that have since been solved.

Receivables That Should Have Been Reversed. At the time a sales contract is awarded, DNSC recognizes revenue from the sale of excess material and generates an account receivable. The contractor often does not remove the material until much later. The price of some commodities is so volatile that it is often not set at the time the contract is awarded, but is indexed to a market indicator that is determined close to the time of removal. Also, with many commodities, it is impossible for the contractor to remove a precise quantity. For these reasons, the amount established as a receivable at the time the contract is awarded is usually an estimate, and the actual amount sold is usually more or less than the estimate. When the amount sold is more than the estimate, the contractor is billed for additional sales; when it is less, the overestimate must be removed from sales and receivables. Part I. B. of this report, "Review of Compliance With Laws and Regulations," discusses the need for a change in the timing of revenue recognition. Of the $2.6 million that should be reversed, $2.3 million was from contracts that were complete but had not been removed from Accounts Receivable. DNSC also charges for storage when contractors do not remove material by the agreed-upon date, and charges interest on delinquent receivables. Of the $2.6 million that should be reversed, $.3 million represented storage or interest charges.

Unposted Collections. Most of the $7.1 million in unposted collections occurred because the DFAS Columbus Center cannot fully post cash collections until they receive confirmation from the Department of the Treasury; in one case, the delay was caused by DNSC and DFAS. Because of the delay, the DFAS Columbus Center posts the collections manually to the contractors' accounts for billing purposes, but does not post them to the official subsidiary accounts receivable ledger. Therefore, the DFAS Columbus Center has two subsidiary accounts receivable ledgers, one ledger shows amounts actually received, and the other shows amounts officially posted.

Because the amounts collected were known, the financial statements should have been adjusted. To eliminate the delay in posting, the DFAS Columbus Center has begun posting collections to an undeposited collections account so that accounts receivable will reflect actual collections. The plan is to clear this account after confirmation from the Department of the Treasury is received and cash can be fully posted. This practice should eliminate the need for two subsidiary ledgers and for any special year-end adjustment to future financial statements.

Conclusion

Because of the delays in writing off uncollectible or invalid receivables, the Accounts Receivables and Net Position of the FY 1997 Fund Financial Statements were overstated by $2.1 million to $2.6 million. The amount of overstatement may be much higher; we did not send requests for confirmation to all contractors, and some contractors did not respond to our requests. The uncertainty of the amount of overstatement was a major reason for our disclaimer of opinion on the financial statements. Because of the delays in posting collections, Accounts Receivable was overstated by $7.1 million, and Fund Balance With Treasury was understated by $7.1 million, on the FY 1997 Fund Financial Statements. The delays also increased the potential for billing errors because of the need to maintain a second, unofficial set of records for billing purposes.

Management Comments on the Finding and Audit Response

DLA Comments on Materiality of Internal Control Weakness. DLA partially concurred that this finding constituted a material internal control weakness, as stated in Appendix A and the introduction to Part I.A. of this report. The basis of the partial nonconcurrence is that DLA does not believe that the finding requires attention at the next higher level of management, as required by DoD Instruction 5010.40. Specifically, DLA does not believe that the finding requires attention outside the Office of Stockpile Contracts.

Audit Response. We believe that attention from top DNSC management is needed to ensure that DNSC achieves and maintains the prompt clearing of completed contracts and related storage and interest charges. Management is implementing the recommendation to bring the issue to the attention of the Administrator, DNSC; therefore, the finding is receiving attention outside the Office of Stockpile Contracts, and we consider this issue resolved.

Recommendations and Management Comments

B.1. We recommend that the Administrator, Defense National Stockpile Center, establish procedures for promptly clearing completed contracts and forwarding information to the Defense Finance and Accounting Service Columbus Center for the reversal of contract amounts and related storage and interest charges.

Management Comments. The Defense Logistics Agency concurred and stated that, as addressed in the management comments on Finding A, DNSC management is evaluating recommendations resulting from a February 1998 visit of DNSC personnel to the DFAS Columbus Center. DNSC management plans to establish procedures to improve contract administration, including the prompt clearing of completed contracts and forwarding information to DFAS Columbus Center. The estimated completion date is August 30, 1998.

B.2. We recommend that the Director, Defense Finance and Accounting Service Columbus Center:

a. Periodically confirm accounts receivable with contractors and resolve any differences.

b. As part of accounts receivable collection, actively inquire about receivables that may need to be reversed.

c. Continue to post known collections to the Undeposited Collections account if they cannot be fully posted, post a corresponding amount to Accounts Receivable, and monitor the Undeposited Collections account to ensure that it is cleared when the collections are fully posted.

Management Comments Required

The Defense Finance and Accounting Service did not comment on a draft of this report. We request that the Defense Finance and Accounting Service provide comments on the final report.

Finding C. Accounting for Silver With the U.S. Mint

DNSC does not adequately manage its silver commodity. Specifically, DNSC does not receive any statements from the U.S. Mint (the Mint) on the amount of silver accountable to the Mint or on consignment. The Fund has a significant liability for silver that it received without reimbursing the Mint. DNSC also has an asset account for a portion of silver that the Mint has taken back on consignment in order to make commemorative coins. The Mint does not provide confirmation because neither organization has addressed the issue of documentation needed to support these transactions. As a result, DNSC managers do not know whether their records are accurate, or whether any discrepancies exist that require corrective action.

Commemorative Coin Program

According to unofficial records at DNSC, in 1968, the Mint transferred 168,000,000 fine Troy ounces of silver to DNSC without reimbursement. At that time, the value was fixed at $1.292929292 per ounce. DNSC and the Mint agreed that DNSC would eventually pay the Mint for the silver at that price. DNSC carries the total remaining balance of the silver as a liability at $1.292929292 per ounce. This liability of about $51.8 million is the major part of the $60.6 million Intragovernmental Accounts Payable on the FY 1997 Fund Financial Statements. Except for the amount on consignment to the Mint, the liability should be offset by an equal amount in the Stockpile Materials account.

In 1985, the Mint began using some DNSC silver for commemorative coins. Periodically, the Mint requests and takes a quantity of silver on consignment to manufacture commemorative coins. In accounting records and financial statements, DNSC moves the total dollar value, at $1.29293 per ounce (the DNSC inventory system accommodates only 5 decimal places in the unit cost field), from Stockpile Materials to Advances and Prepayments. See Finding F for a discussion of the use of this account.

Each month, the Mint reports the coins actually sold and the number of ounces of silver used. The Mint remits funds to DNSC at the current market value, now much higher than $1.292929292 per ounce, minus the original cost, and also minus refining and transportation charges. DNSC records the entire market value of the silver as Intragovernmental Revenue, records the original cost of $1.292929292 per ounce as Cost of Goods Sold, and records other charges as Program or Operating Expenses. The remainder is the amount of cash actually received. At the same time, DNSC reduces both Advances and Prepayments and Other Government Liabilities for the number of ounces sold at $1.292929292 per ounce.

Written Confirmation To Support Silver

General Absence of Confirmation. The Mint provides statements of quantities of silver taken into consignment and quantities of coins sold, but no statements of the remaining quantities on consignment or the quantities not yet taken into consignment. An official at the Mint stated that the Mint has its own records of both amounts, and neither organization had considered providing or requesting regular written statements of balances.

The Mint provided us with a written statement as of September 30, 1997. After accounting for a timing difference in the coin sales for September 1997, the amount on consignment was only $37.09 more on DNSC records than on the Mint's records. However, the amount not yet taken into consignment was $70,544.37 more on DNSC records than on the Mint's records. The Mint found about $62,000 of this discrepancy in an error in its records, and planned to correct the error.

Negative Consignment Balance. As of September 30, 1996, the DNSC consignment balance was negative, and was listed as a negative "Advances and Prepayments" on the FY 1996 Fund Financial Statements. The negative balance implied that the Mint had paid DNSC for more silver than it had taken on consignment. DNSC had no written documentation to support this position.

DNSC believed that the Mint does not physically separate the DNSC consignment silver from other silver. Also, DNSC believed that the negative balance arose because the Mint ran out of DNSC silver and used other silver for commemorative coins, paying DNSC later for coins sold made with the other silver. Officials from the Mint confirmed this explanation, adding that the anomalous balance shows up in the Mint's accounting records as it does in DNSC records. In early 1997, the Mint took more silver on consignment. After this transaction was posted, DNSC no longer had a negative consignment balance. The Mint officials stated that the Mint has recently instituted a procedure to ensure that it takes additional DNSC silver on consignment before the balance can become negative again.

Conclusion

Because of the lack of written confirmation from the Mint on the amounts of silver in each category, DNSC does not have assurance that the Mint's balances agree with DNSC balances. The Mint and DNSC should agree on the amount of silver on consignment because DNSC expects to be paid for that amount of silver in the near future, when coins are sold. The two organizations should also reconcile their accounts because the Mint does not physically segregate the DNSC silver. The Mint and DNSC should also agree on the quantity of remaining silver, because the Mint eventually expects to receive all of the DNSC silver at the discount of $1.292929292 per ounce, and DNSC eventually expects to be paid for all of it. The negative amount on the FY 1996 Fund Financial Statements was unclear to the users of the financial statements, and DNSC still has no assurance that the explanation is correct.

Recommendations and Management Comments

C. We recommend that the Administrator, Defense National Stockpile Center:

1. Request that the U.S. Mint provide periodic written statements on the total amount of silver at the Defense National Stockpile Center and the amount on consignment.

2. Request that the U.S. Mint provide a written explanation of the negative consignment balance as of September 30, 1996.

Management Comments. DLA concurred and stated that DNSC will request from the Mint both a consignment balance as part of the Mint's monthly report of sales, and a written verification of the remaining inventory balance following the release of silver for consignment. DNSC will reconcile any differences immediately. DNSC will also ask the Mint to provide a written explanation of the circumstances that resulted in a negative consignment balance as of September 30, 1996. The estimated completion date is September 30, 1998.

Part I. B. - Review of Compliance With Laws and Regulations

Introduction

We reviewed compliance with applicable laws and regulations to obtain reasonable assurance that the financial statements were free of material misstatements, not to render an opinion on the overall compliance with such provisions. As part of obtaining reasonable assurance that the financial statements were free of material misstatements, we reviewed compliance with laws and regulations directly affecting the financial statements and with other laws and regulations designated by OMB and DoD. The Chief Financial Officer, DoD; the Director, DFAS; the Director, DLA; the Comptroller, DLA; and DNSC management are responsible for ensuring compliance with laws and regulations applicable to the Fund. See Appendix E for a list of the laws and regulations we reviewed.

Reportable Noncompliance

Material instances of noncompliance are failures to follow requirements, laws, or regulations that would cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant. Our reviews indicate that management generally complied with the selected provisions of laws and regulations as they pertained to the accuracy of the financial statements. We did not detect any instances of material noncompliance. However, DNSC did not comply with guidance on material with a value lower than its acquisition cost, funds from the sale of certain commodities, and the preparation of financial statements. A compliance issue regarding the recording of pension expenses in the financial statements was previously identified in the audit of the FY 1996 Fund Financial Statements.

The Fund also did not comply with the DoD Financial Management Regulation, volume 4, chapter 3, and volume 10, chapter 18, as related to the internal control weaknesses in Part I.A. These compliance issues were previously identified in the audit of the FY 1996 Fund Financial Statements. Compliance issues identified during our review did not have a material impact on the overall financial statements. With respect to the items not tested, we found nothing that caused us to believe that the Fund managers had not complied, in all material respects, with the provisions identified above.

Material with a Value Lower Than Acquisition Cost. DNSC did not reduce the value of Stockpile Materials for commodities that had declined in value below acquisition cost or had known shortages. Therefore, DNSC did not comply with Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," October 27, 1993. The noncompliance is discussed in detail in Finding D.

Retention of Funds From the Sale of Certain Commodities. According to Public Law 104-201, "National Defense Authorization Act for Fiscal Year 1997," September 23, 1996, DNSC should have transferred funds collected from the sale of certain commodities to the General Fund of the U.S. Treasury. DNSC inappropriately maintained a portion of these funds. The noncompliance is discussed in detail in Finding E.

Financial Statement Compliance With Regulations. DNSC did not fully comply with the DoD Financial Management Regulation, volume 6, chapter 6, "Form and Content of Audited Financial Statements," January 1998. Chapter 6, although dated January 1998, was in effect for the financial statements prepared for FY 1997. DNSC had draft guidance that was to be used in preparing the financial statements. We used the draft guidance and reviewed the final version, dated January 1998, to ensure that there was no effect on our findings. The financial statements did not comply with the regulations when recognizing pension expenses and the liability for environmental cleanup; classifying silver on consignment to the U.S. Mint; and allocating amounts to Cumulative Results of Operations. We also identified the issue of pension cost in our audit of the FY 1996 Fund Financial Statements. The noncompliance is discussed in detail in Finding F.

Collection of Accounts Receivable. DNSC and the DFAS Columbus Center did not comply with DoD Financial Management Regulation, volume 4, chapter 3, and volume 10, chapter 18; and with Public Law No. 104-304, the "Debt Collection Act of 1996," April 25, 1996, for the collection of accounts receivable and the referral of delinquent receivables to the DFAS Columbus Center's Debt Management Office. Problems with delinquent accounts receivable were also identified in the audit of the FY 1996 Fund Financial Statements. Finding A discusses the collection of accounts receivable.

Revenue Recognition. For disposal sales of excess material, DNSC recognizes revenue and the related receivable at the time the contract is awarded. DNSC implemented this practice in accordance with DoD 7220-M, the "DoD Accounting Manual," chapter 64, "Revenues," October 1983. Beginning in FY 1994, SFFAS No. 3 required that when stockpile material is sold, the cost of goods sold must be recognized at the time the title passes or goods are delivered. To match revenues and expenses correctly, revenues and cost of goods sold must be recognized at the same time. In FY 1997, DNSC recognized revenues and cost of goods sold at the same time; however this was done at the time the contract was awarded, not at the time the title passed or goods were delivered, contrary to SFFAS No. 3. Beginning in FY 1998, SFFAS No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," May 10, 1996, requires revenue recognition at the time of delivery of goods or services. DNSC plans to conform with both SFFAS No. 3 and No. 7 in FY 1998.

Although the method of revenue recognition on the FY 1997 Fund Financial Statements was not in compliance with SFFAS No. 3, this report contains no findings or recommendations on revenue recognition. The actions planned by DNSC to meet the requirements of SFFAS No. 7 should also meet the requirements for the FY 1998 financial statements. Any effect on financial disclosures in FY 1997 and earlier should be shown as prior-period adjustments in FY 1998.

Title 31, U.S.C. 3512, "Federal Financial Management Improvement Act of 1996." On September 9, 1997, the Office of Management and Budget (OMB) issued a memorandum, "Implementation Guidance for the Federal Financial Management Improvement Act (FFMIA) of 1996." The FFMIA requires Federal agencies to implement and maintain financial management systems that comply substantially with Federal requirements for financial management systems, applicable Federal accounting standards, and the U.S. Government Standard General Ledger (USGSGL) at the transaction level. The FFMIA also requires that we report on agency compliance with Federal requirements and accounting standards and the USGSGL. These requirements are well-established in the following Federal policy documents.

- OMB Circular No. A-127, "Financial Management Systems," July 23, 1993, establishes Government policy for developing, evaluating, and reporting on financial management systems. It requires financial management systems to provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD and other Federal agencies must establish and maintain a single, integrated financial management system using the USGSGL.

- OMB Circular No. A-134, "Financial Accounting Principles and Standards," May 20, 1993, establishes policies and procedures for approving and publishing financial accounting principles and standards. It also establishes the policies that Executive agencies and OMB are to follow in seeking and providing interpretations and other advice related to the standards.

- The Joint Financial Management Information Program (JFMIP) is a cooperative undertaking of the OMB, the Department of the Treasury, and the Office of Personnel Management, working with each other and with operating agencies to improve financial management practices throughout the Government. The JFMIP has published a series of "Federal Financial Management System Requirements."

- The "Core Financial System Requirements," September 1995, which are part of the JFMIP "Federal Financial Management System Requirements," establish standard requirements for the foundation modules of an agency's integrated financial management system. These requirements state that a financial management system must support the partnership between program and financial managers and assure the integrity of information for decisionmaking and performance measurements.

As part of our audit to obtain reasonable assurance about whether the FY 1997 National Defense Stockpile Center Transaction Fund Financial Statements are free of material misstatement, we performed tests of compliance with certain provisions of laws and regulations when noncompliance could have a direct and material effect on the determination of amounts in the financial statements. We also tested compliance with other laws and regulations specified in OMB Bulletin No. 93-06, as modified by OMB Bulletin No. 98-04. In planning and performing our tests of compliance, we considered the implementation guidance issued by OMB on September 9, 1997, relating to the FFMIA.

Weaknesses in DoD accounting systems have been reported since we began auditing DoD financial statements, as required by the CFO Act. Data from the deficient systems were used to prepare the FY 1997 Fund Financial Statements. DFAS and DNSC acknowledged that the Standard Army Financial System (STANFINS) Redesign Subsystem One was not in compliance with accounting requirements.

Until a migratory strategy is established and accounting systems are selected, DNSC management will not be able to determine the time frames and costs of installing accounting systems that comply with the Chief Financial Officers Act of 1990 and the FFMIA and can produce auditable financial statements.

Conclusion. DNSC and the DFAS Columbus Center should implement the regulations, standards, and generally accepted accounting principles discussed in Parts I.A. and I.B. to resolve problems with the collection of accounts receivable, valuation of inventory, transfer of funds from the sale of certain commodities, preparation of the financial statements, and recognition of revenue. The findings in this report include recommendations for each compliance issue, except for revenue recognition and the allocation of funds to Cumulative Results of Operations.

Finding D. Value of Inventory

The DNSC Master Inventory File (MIF) and an inventory line item account on the FY 1997 Fund Financial Statements, Stockpile Materials, were overstated. This occurred because DNSC did not take timely action to decrease the carrying value of inventory that had declined in value or to write off identified inventory shortages. Specifically, DNSC did not decrease the carrying value of inventory that had declined in value because DNSC employees were not aware of the requirement. DNSC did not write off identified shortages because DNSC had no procedures to track and ensure that depleted commodities were written off. In addition, DNSC procedures did not require action on most shortages that are a small percent of total quantity, regardless of the dollar amount, and DNSC personnel believed that missing material may be located, which could reduce the shortages. As a result, Stockpile Materials and Net Position, two line items on the FY 1997 Fund Financial Statements, were overstated by at least $90.0 million. This represented 2.7 percent of the $3.32 billion in Stockpile Materials. Furthermore, the lack of action on identified shortages delayed any investigation and decreased the likelihood of recovering any material.

Disclaimer of Opinion

Our disclaimer of opinion on the FY 1997 Fund Financial Statements was largely based on the fact that we did not have data on bulk commodities in our statistical sample; therefore, we could not project the sample results to the entire Stockpile Materials line item account. The next section discusses specific adjustments that should be made to Stockpile Materials and is not based on projection of the sample, although some items were part of the sample.

Inventory Valuation

Criteria. SFFAS No. 3 states that in FY 1994, for stockpile materials that have declined in value below original cost, the decline in value should be removed from the carrying value of the inventory and should be recognized as a loss in the period in which the loss occurs.

Commodities That Have Declined in Value. DNSC personnel stated that at least three commodities were excess to national defense requirements, but could not be sold because of environmental restrictions. The commodities were asbestos, mercury, and thorium nitrate. These commodities represented $52.9 million on the FY 1997 Fund Financial Statements, but had no realizable value. DNSC personnel believed that additional commodities had also declined in realizable value below the original cost at which they were valued on the financial statements. DNSC should recognize the loss for all materials that have declined in value below the acquisition cost, in accordance with SFFAS No. 3, and should begin by writing off the entire value of commodities with no realizable value. The loss from writing off the recorded value would be in addition to any estimated costs of environmental cleanup of the commodities. Finding F discusses environmental cleanup costs. Since September 30, 1997, DNSC has disposed of and written off asbestos valued at $367,388, incurring disposal expenses of $370,000. As required by SFFAS No. 3, DNSC should not wait until disposal to write off the carrying value of the hazardous material. Because the necessary adjustments had not been made for FY 1997, the values of Stockpile Materials and Net Position on the FY 1997 Fund Financial Statements were overstated by at least the $52.9 million for the commodities with no realizable value.

DNSC periodically reports to Congress on the market value of commodities. In addition to asbestos, mercury, and thorium nitrate, DNSC reported that jewel bearings had no market value as of September 30, 1997. The acquisition value of jewel bearings reflected in the FY 1997 Fund Financial Statements is about $36 million. This amount also represents an overstatement of Stockpile Materials and Net Position.

Identified Inventory Shortages

Depleted Material Pending Write-off. Although SFFAS No. 3 does not specifically mention shortages, missing material is not available and is no longer of any value to the Government. When the entire amount of a bulk commodity has been shipped, a positive or negative balance usually remains on the inventory records. This condition is expected because the material has been exposed to the elements for a number of years and can absorb moisture, the weight increases, or sinks into the ground, causing the weight actually available for shipment to decrease. DNSC places such balances in a special class in the MIF pending write-off of the positive or negative balance. DNSC includes the net amount of these balances in the Fund financial statements.

To determine whether items were correctly placed in the special class for material pending write-off, we reviewed the four largest balances in that class, as shown by the MIF on May 31, 1997. Three balances were positive, indicating shortages, and one was negative, indicating an overage. We confirmed that all four balances represented no actual material. In three of the four cases, the entire amount of material had been shipped, but its value had not been written off as of March 1998. The overage amounted to $171,004, and the two shortages totaled $235,925. The situation regarding the fourth discrepancy is described below.

The largest of the four balances was for nickel valued at $448,590 that was stored at the DNSC depot at Ravenna, Ohio. DNSC provided records indicating that a theft of this material was suspected and investigated in 1979, before the bulk commodities were transferred to DoD from the General Services Administration (GSA). The nickel was stored in a tank, and the amount stolen could not be determined without removing the nickel from the tank and weighing it. GSA had not determined the amount stolen. During January through March 1995, the nickel from this tank was moved to the DNSC depot at Warren, Ohio. The nickel was weighed as it was removed, and the recorded balance of nickel was reduced by the amount removed. After removal, records for the DNSC depot at Ravenna had a balance of 820,897 pounds of nickel valued at $488,590. In March 1995, DNSC employees knew that this material would not be recovered, but as of March 1998, the value of the nickel had not been written off.

As of September 30, 1997, DNSC had 100 balances pending write-off with a value (shortages minus overages) of $380,233, including the balances discussed above. Therefore, the Stockpile Materials and the Net Position of the Fund were overstated by $380,233 in the FY 1997 Fund Financial Statements.

Additionally, not all material pending write-off had been placed in the special class. We reviewed MIF data on material with a combined weight of 31,084,640 pounds, valued at $516,843, which had been completely shipped by May 31, 1997, but had not been placed in the special class for write-off as of March 1998. The Stockpile Materials and the Net Position of the Fund were overstated by $516,843 for this material. Other MIF data may also exclude nonexistent material.

Physical Shortages Identified in Audit Sample. For physical verification, we selected a statistical sample of items from the MIF extract of May 31, 1997. We found two significant shortages in the countable sample items: lead at the DNSC depot at Hammond, Indiana, and zinc at the DNSC depot at New Haven, Indiana. For both of these items, shortages had already been identified in Quality Assurance reviews performed by DNSC. However, according to the Quality Assurance review, the shortage at the DNSC depot in Hammond was much less than what we identified. In accordance with DNSC procedures, no action had been taken on the shortages identified by the Quality Assurance review because they were within the prescribed percentage (2 percent for some commodities and .5 percent for others) of the total quantity of those commodities.

At the DNSC depot in Hammond, we identified a shortage of 8,029 pieces of lead. The most recent Quality Assurance report, issued on March 27, 1997, showed a smaller but still significant shortage of 2,611.5 pieces. In February 1998, at our request, DNSC thoroughly reviewed the lead stored at the DNSC depot in Hammond and found the following.

- An inventory taken on June 21, 1977, found a shortage of 7,850 pieces of lead.
- Since June 2, 1978, Quality Assurance reports showed approximately the same shortage as that found on March 27, 1997 (2,611.5 pieces).
- DNSC made two independent counts in February 1998; according to both counts, the shortage was 6,815 pieces.

DNSC concluded that a shortage of 6,815 pieces was accurate and that inventory records should be adjusted. Although the variations among the counts were unexplained, the two independent counts taken in February 1998 were probably the most correct because they were independent and received extra attention from auditors and senior DNSC management. DNSC should make the adjustment for the shortage of 6,815 pieces. Using the average value of $14.65 for a piece of lead at the DNSC depot at Hammond, the adjustment would be $99,840.

At the DNSC depot at New Haven, Indiana, we found a shortage of 1,562 pieces of zinc, almost exactly equal to the shortage of 1,564 pieces shown in the most recent Quality Assurance report issued on April 4, 1997. Depot personnel stated that two pieces were found during the summer of 1997, explaining the difference in the results. In a memorandum issued on February 4, 1998, depot personnel reported that the shortage of 1,564 pieces was shown in a quality assurance report in February 10, 1995. The memorandum accounted for 10 missing pieces but stated that 1,552 pieces were missing. Depot personnel believe that these pieces may be found. However, the records should be adjusted until the pieces are found; at that time, the adjustment can be reversed. The value of the adjustment would be $11,485.

DNSC should set an amount above which shortages are investigated and adjusted, in addition to the existing percentage threshold. Quantities of DNSC materials are large enough that small percentages can be significant.

Depot Records and the MIF. In addition to the MIF, the DNSC depots keep manual records of quantities on hand. Because the amounts reported in the financial statements are based on the MIF, errors should be detected and corrected, and reconciliation with depot records is a method of doing this. In our audit of the FY 1995 Fund Financial Statements, we noted that discrepancies often existed between the depot records and the MIF. These discrepancies were separate from any physical discrepancies described in this finding, and represented errors in posting to the MIF or to the depot records. In August and September 1996, DNSC made an effort to reconcile the MIF to depot records and resolved all differences within 2 percent of the quantity on hand. DNSC also originally planned to reconcile all differences over $5,000, but did not complete that effort. However, DNSC has continued to reconcile some of the larger remaining differences.

MIF Errors Identified in FY 1997 Audit Sample. Three sample items had significant discrepancies between depot records and the MIF. Two of the discrepancies support the original DNSC plan to reconcile differences above a fixed dollar amount as well as above the 2-percent quantity threshold. Both were bulk items stored at the DNSC depot in Point Pleasant, West Virginia, and the same discrepancies were found when DNSC reconciled the MIF to depot records in FY 1996. However, DNSC did not investigate these discrepancies because they were within 2 percent of the total quantity. The specific commodities were high-carbon ferro-manganese (depot records showed 30,000 pounds more than the MIF) and high-carbon ferro-chromium (the MIF showed 390,880 pounds more than depot records). If the MIF is incorrect, the

30,000-pound difference would have caused an understatement of $8,720 in the FY 1997 Fund Financial Statements. DNSC personnel have not determined the cause of this difference. The 390,880-pound discrepancy, valued at $104,541, is more significant; DNSC plans to research it immediately. DNSC personnel believe that the MIF is overstated, which would cause an overstatement on the FY 1997 Fund Financial Statements.

The last of the three items, cadmium stored at the DNSC depot at Somerville, New Jersey, demonstrates the need to continue performing the reconciliations. The cadmium was stored in boxes that could be counted, and our physical count agreed with the depot records. Additionally, the 1996 reconciliation by DNSC showed that the difference between the MIF and the depot records was 3.2 pounds. However, as of May 31, 1997, the MIF showed 29,428.46 pounds more than the depot records. This difference occurred because of an error in the MIF posting of a September 1996 shipment. The error was corrected in October 1997. Because DNSC reduces inventory and recognizes Cost of Goods Sold at the time of awarding a contract, there is no additional effect on accounting records at the time goods are shipped. Therefore, the September 1996 error was not reflected on the FY 1996 or 1997 Fund Financial Statements. However, when DNSC changes its method of recognizing revenue as noted in Finding F, such errors, if not corrected in a timely manner, will affect the financial statements.

MIF Adjustment Made After September 30, 1997. In January 1998, DNSC wrote off $47,784.93 in diamond stones stored at Citibank in New York, New York, because they believed the MIF was in error. However, the DNSC reconciliation in 1996 found no difference between the MIF and the depot records for this commodity. The $47,784.93 was an additional overstatement of Stockpile Materials in the FY 1997 Fund Financial Statements.

Conclusion

DNSC should continue its commendable efforts to reconcile the MIF and depot records. However, the unrecorded declines in value and unrecorded shortages caused overstatements of Stockpile Materials and the Net Position on the FY 1997 Fund Financial Statements. On the FY 1997 Fund Financial Statements, at least $90.0 million (2.7 percent of the $3.32 billion in Stockpile Materials) was attributable to unrecorded declines in value and unrecorded shortages. Additionally, the lack of attention to these shortages delayed investigation and decreased the likelihood that commodities or funds would be recovered.

Recommendations, Management Comments, and Audit Response

D. We recommend that the Administrator, Defense National Stockpile Center:

1. Identify commodities that have decreased in value below the recorded acquisition cost and reduce the Stockpile Materials line item account by the amount of the decrease.

Management Comments. DLA concurred, stating that Statement of Federal Financial Accounting Standards No. 3 requires materials to be valued at historical cost except when the material has permanently declined in value. The decline is to be recognized as a loss in the period in which it occurs. DLA stated that DNSC had identified all commodities with permanent declines in value and will reduce the Stockpile Materials line item account. Also, DLA stated that DNSC would continue to adjust the Stockpile Materials line item account for any material that has a permanent decline in value in the future. The estimated completion date is September 30, 1998.

2. Begin writing off all commodities known to be pending write-off, and require that such commodities be written off promptly in the future.

Management Comments. DLA concurred, stating that DNSC already has an established procedure for inventory adjustments. When all pertinent information has been obtained, the depot manager prepares a request for an inventory adjustment forwards it to Headquarters, DNSC, for approval. After review and concurrence by DNSC counsel, the adjustment is approved by the Director, Directorate of Strategic Materials Management, or the Administrator, DNSC. To improve compliance with this procedure, DLA stated that DNSC will produce a quarterly listing of commodities pending write-off as a reminder to personnel who need to take action. Management considers the action complete.

3. Revise procedures to require the investigation and write-off of identified shortages, including both physical shortages and discrepancies in the Master Inventory File, that are over a fixed dollar value or a fixed percentage of quantity.

Management Comments. DLA nonconcurred, stating that DNSC uses computed counts for many commodities for which actual counts are too difficult to be cost-effective. Because the computed counts are estimates, DNSC does not adjust for discrepancies until the entire amount of the commodity is shipped and an exact overage or shortage can be determined. DLA further stated that acquisition values either overstate or understate the current value of material, but market values fluctuate constantly. A fixed percentage of quantity is the only measurement that is not affected by the variables of acquisition value or market value.

Audit Response. We consider the management comments partially responsive. We are aware that computed counts are the only practical method of counting many DNSC commodities, and that the computed counts are not exact. However, in the examples from our physical inventory, the shortages were in thousands of pieces; and based on our own observation, the items were not in condition that carefully computed counts could have been off by large quantities. Further, the two commodities have consistently shown shortages over a period of years. Specifically, the stockpile of lead at the Hammond Depot has shown a shortage for over 20 years. Under such circumstances, it is reasonable to conclude that a shortage exists, and SFFAS No. 3 requires an adjustment of the inventory records.

Because the computed counts are not exact, we agree that it is not worthwhile to adjust the inventory records for insignificant shortages. However, it is necessary to determine whether the dollar value of identified shortages are significant. For compliance with SFFAS No. 3, the relevant dollar value is the financial statement value, which, as established in this finding, should be the lower of the acquisition cost or the market value. The dollar value on the financial statements must be a factor in determining whether to adjust for identified physical shortages. Therefore, we request that DLA provide additional comments in response to the final report.

4. Direct that depot records be reconciled at least annually with the Master Inventory File.

Management Comments. DLA concurred, stating that DNSC had approved a new procedure requiring the annual reconciliation of depot records with the MIF. DLA enclosed a copy of the procedure with its response to the draft audit report. The action is considered complete.

Finding E. Retention of Funds

DNSC inappropriately retained approximately $51.16 million that should have been transferred to the General Fund of the U.S. Treasury. Public Law 104-201, "National Defense Authorization Act for Fiscal Year 1997," September 23, 1996, section 3303, requires the sale of 11 designated Stockpile commodities over a 10-year period, with the proceeds deposited to the General Fund of the U.S. Treasury. The law states that receipts should be $81 million in the first year (FY 1997) and should total $612 million for the entire 10 years. DNSC collected about $132.16 million from sales of these commodities in FY 1997, but transferred only $81 million to the U.S. Treasury. DNSC only transferred $81 million because the Revolving Fund Directorate, Under Secretary of Defense (Comptroller), interpreted the law to mean that the General Fund of the U.S. Treasury should receive $81 million during FY 1997. As a result, $51.16 million that remained in the Fund should have been transferred to the General Fund of the U.S. Treasury. Because DNSC followed the guidance established by the Under Secretary of Defense (Comptroller), Fund Balance With Treasury line item and the Other Federal (Intragovernmental) Liabilities line item were overstated by $51.16 million on the FY 1997 Fund Financial Statements. After the audit field work, DNSC deposited into the General Fund of the U.S. Treasury all funds received from dispositions under Public Law 104-201, section 3303.

Requirements of Public Law

Public Law 104-201 states that the proceeds from the sale of 11 excess Stockpile commodities should be set aside to offset certain costs of foreign military sales for which the U.S. Government waives recovery. The law states that proceeds from these sales should total $612 million over a 10-year period, and $81 million during FY 1997. The law also states that proceeds from these sales should be deposited to the General Fund of the U.S. Treasury.

Transfer of Proceeds

During FY 1997, DNSC sold quantities of 9 of the 11 excess commodities valued at about $184.94 million, and collected about $132.16 million. DNSC deposited all proceeds into the Fund. Late in FY 1997, DNSC transferred $81 million to the General Fund of the U.S. Treasury, but retained the other $51.16 million in its Fund Balance with Treasury account. In the FY 1997 Fund Financial Statements, this amount in Fund Balance With Treasury was offset by a liability for Other Federal (Intragovernmental) Liabilities, correctly reflecting the fact that DNSC must relinquish these funds. Therefore, the Net Position of the Fund was not overstated.

DNSC personnel stated that the Revolving Fund Directorate, Under Secretary of Defense (Comptroller), made the decision to transfer $81 million. The responsible official in the Revolving Fund Directorate stated that he had interpreted the law to mean that the General Fund of the U.S. Treasury should expect to receive $81 million during FY 1997, and that the National Defense Stockpile Transaction Fund should retain the additional proceeds for future requirements. However, Public Law 104-201 states that proceeds should go to the General Fund of the U.S. Treasury, although the general provision in a different law states that the Fund is allowed to retain its own funds. Therefore, DNSC did not have the authority to retain proceeds from these sales. We agree that depositing funds can be initially deposited in the National Defense Stockpile Transaction Fund if the transfer to the General Fund of the U.S. Treasury is made promptly. DNSC deposited into the General Fund of the U.S. Treasury all funds received from dispositions under Public Law 104-201 section 3303.

Recommendations for Corrective Action

E. We recommend that the Under Secretary of Defense (Comptroller):

1. Transfer all additional proceeds to date from sales of the eleven commodities to the General Fund of the U.S. Treasury.

2. Promptly transfer all future proceeds from sales of the designated commodities to the General Fund of the U.S. Treasury.

Management Comments Required

The Under Secretary of Defense (Comptroller) did not comment on a draft of this report. We request that the Under Secretary of Defense (Comptroller) provide comments on the final report.

Finding F. Financial Statement Compliance With Regulations

The FY 1997 National Defense Stockpile Transaction Fund Financial Statements did not fully comply with the DoD Financial Management Regulation, volume 6, chapter 6, "Form and Content of Audited Financial Statements," January 1998, and other criteria. Specifically, the statements did not disclose pension costs and environmental cleanup liabilities; misclassified silver inventory on consignment to the U.S. Mint; and did not properly add the FY 1997 operating results to Cumulative Results of Operations. The noncompliance problems occurred because the preparers did not know where to obtain information and how to correctly present these amounts. As a result, the FY 1997 Fund Financial Statements contained nonmaterial misstatements; therefore, the financial statements did not completely disclose the financial position of the Fund.

Pension Costs

IG, DoD, Report No. 97-176 noted that the FY 1996 statements did not reflect pension costs, as required by the DoD Financial Management Regulation. SFFAS No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995, effective in FY 1997, requires Federal employers to recognize pension expense at the actuarial present value of benefits attributed by the pension plan's benefit formula to services rendered by employees during the accounting period. The FY 1997 Fund Financial Statements did not disclose pension costs. DNSC personnel told us that they did not know where to obtain the actuarial information they needed to determine these costs.

Environmental Cleanup

SFFAS No. 5 requires recognition of a contingent liability for any estimable probable outlay resulting from a past event. If the outlays are probable but not reasonably estimable, the existence of the liability is to be disclosed in the footnotes to the financial statements. For DNSC, the past event is the delivery of hazardous material to the DNSC depots, and future outlays are for cleanup requirements.

DNSC has several hazardous materials that cannot be sold, including mercury, asbestos, and thorium nitrate; others, such as lead, require cleanup after the entire quantity has been sold. Since September 30, 1997, DNSC has spent approximately $370,000 to dispose of asbestos. In the notes to the FY 1997 Fund Financial Statements, DNSC did not accrue a contingent liability or disclose such a liability. DNSC management believes that this situation does not meet the criteria for a contingent liability because at present, the material is properly contained and does not pose an environmental hazard. DNSC also includes funds for current cleanup in its annual budget; therefore, management does not believe that an ongoing liability will exist in the future. Beginning in FY 1999, DNSC plans to include an additional $13.8 million in its budget, in addition to the $14.7 million to be spent on cleanup during FY 1999 (a total of $28.5 million), to pay for any remaining cleanup needed after all DNSC disposal sales are completed.

Although it is commendable that DNSC budgets in advance for environmental cleanup, the intent of SFFAS No. 5 is to disclose all known, required future outlays. Therefore, for financial statement purposes, DNSC should include an estimate of the total future outlays for environmental cleanup as a contingent liability. This estimate should include at least the $28.5 million in the FY 1999 budget request, plus estimates for expenditures in all applicable future years.

Silver on Consignment to the U.S. Mint

As discussed in Finding C, the U.S. Mint has transferred a large quantity of silver to DNSC, and periodically takes some of the silver back on consignment for manufacturing commemorative coins. DNSC has classified the amount on consignment as Advances and Prepayments in the financial statements. According to the DoD Financial Management Regulation, volume 6, chapter 6, amounts classified as Advances and Prepayments are cash outlays to cover periodic expenses before they are incurred. The value of the silver consigned to the U.S. Mint is not a cash outlay and does not cover periodic expenses. To account for the silver on consignment, DNSC should designate a subaccount of Stockpile Materials or account for the silver under Other Assets. In future financial statements, DNSC should include this amount with Stockpile Materials or include it in Other Federal (Intragovernmental) Assets.

Cumulative Results of Operations

On the FY 1997 Fund Financial Statements, the Cumulative Results of Operations should have shown a $101.96 million increase over the FY 1996 amount for Excess (Shortages) of Revenues and Financing Sources Over Total Expenses. Instead, the Cumulative Results of Operations decreased from the FY 1996 amount, based on an earlier version of the statements that showed a negative balance for Excess (Shortage) of Revenues and Financing Sources Over Total Expenses. The failure to make the applicable changes resulted from a lack of understanding of the requirement. As a result, Cumulative Results of Operations was understated, and Invested Capital was overstated. Beginning in FY 1998, according to the Treasury Financial Manual Transmittal Letter No. S2 97-01, volume No. I, May 16, 1997, there will no longer be a requirement for Invested Capital and Cumulative Results of Operations to be separate categories. Therefore, since all the applicable transactions will be placed directly into the Cumulative Results of Operations and will not require an year-end adjustment with Invested Capital, we are not making a recommendation on this issue.

Recommendations, Management Comments, and Audit Response

F. We recommend that the Administrator, Defense National Stockpile Center:

1. Determine the amount of pension expense required and record it in the accounting records in accordance with Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995.

Management Comments. DLA concurred, stating that DNSC will take aggressive action to determine the amount of pension expense required and record it in the accounting records. The estimated completion date is August 30, 1998.

2. Determine the total estimated amount for environmental cleanup and record it as a contingent liability in the accounting records.

Management Comments. DLA concurred with the intent of the recommendation, but stated that DNSC does not agree that the amount for environmental cleanup is a contingent liability. See the text of the DLA comments in Part III of this report, including the comments on Finding F, for the reasons DNSC does not consider environmental cleanup a contingent liability. DNSC agrees that there will be future operating costs and plans to use the Treasury General Ledger Account, Accrued Cleanup Costs, to record estimated future outlays.

Audit Response. The management comments were partially responsive. We support the DNSC plan to report the estimated future outlays for environmental cleanup as a liability. However, as pointed out in the DLA comments, the Treasury Financial Manual defines the account for Accrued Cleanup Costs as the "removing, containing, and/or disposing of hazardous materials associated with the current portion of general and stewardship property, plant, and equipment operations." The costs to dispose of and clean up after stockpile materials are not associated with general or stewardship property, plant, and equipment operations. Furthermore, OMB Bulletin No. 97-01 identifies accrued environmental cleanup costs as contingent liabilities. Although SFFAS No. 5 cites, as an example of a contingent liability, a case in which a Federal agency has breached a contract and is subject to a legal claim, the definition of a contingent liability does not mention legal claims or state that the agency with a contingent liability performed incorrectly. Because the DNSC estimated cost of future environmental cleanup does not meet the definition of Accrued Cleanup

Costs, we continue to believe that cleanup should be as a contingent liability on future financial statements, in accordance with OMB Bulletin No. 97-01. We request an additional response from the DLA on this recommendation.

3. Reclassify the account for silver on consignment from Advances and Prepayments to a subaccount of Stockpile Materials or to Other Assets, and report it in Stockpile Materials or Other Federal (Intragovernmental) Assets on future statements.

Management Comments. DLA concurred and stated that the DNSC will instruct the DFAS Columbus Center to change the account used for silver on consignment from Advance to Government Agencies to Other Assets. DNSC will also report silver on consignments as Other Assets on future financial statements. The estimated completion date is July 1, 1998.

Part II - Additional Information

Appendix A. Audit Process

Scope

Statements Reviewed. We audited the FY 1997 National Defense Stockpile Transaction Fund Financial Statements. The financial statements included the Statement of Financial Position, the Statement of Operations and Changes in Net Position, and the Statement of Cash Flows. Also included were the Footnotes and the Overview to the Principal Statements. We based our opinion on the financial statements dated September 30, 1997; we received the statements on February 10, 1998.

Auditing Standards. We conducted this financial statement audit in accordance with generally accepted auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and OMB Bulletin No. 93-06, as amended by OMB Bulletin No. 97-01. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. We relied on the guidelines suggested by the General Accounting Office and our professional judgment in assessing the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles. Accounting principles and standards for the Federal Government are under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to three officials for approval. Those officials are the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States. The Director, OMB, and the Comptroller General issue standards agreed on by the three officials.

To date, seven Accounting Standards and two Accounting Concepts have been published in final form. Accounting Standard No. 8 has been approved by the Federal Accounting Standards Advisory Board, but it must be reviewed by Congress before it is issued. In addition, the Federal Accounting Standards Advisory Board issued an exposure draft, "Amendments to Accounting for Property, Plant, and Equipment," February 13, 1998, proposing amendments to Accounting Standards No. 6 and No. 8. These standards and concepts constitute generally accepted accounting principles for the Federal Government. OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01, incorporates these standards and concepts and should be used by Federal agencies to prepare financial statements. The table on the next page lists the "Statements of Federal Financial Accounting Standards and Concepts."

Statements of Federal Financial Accounting Standards and Concepts

Accounting Standards and Concepts	Title	Status	Fiscal Year Effective
Standard No. 1	Accounting for Selected Assets and Liabilities, March 30, 1993	Final	1994
Standard No. 2	Accounting for Direct Loans and Loan Guarantees, August 23, 1993	Final	1994
Standard No. 3	Accounting for Inventory and Related Property, October 27, 1993	Final	1994
Standard No. 4	Managerial Cost Accounting Concepts and Standards, July 31, 1995	Final	1998
Standard No. 5	Accounting for Liabilities of the Federal Government, December 20, 1995	Final	1997
Standard No. 6	Accounting for Property, Plant and Equipment, November 30, 1995	Final*	1998
Standard No. 7	Accounting for Revenue and Other Financing Sources, May 10, 1996	Final	1998
Standard No. 8	Supplementary Stewardship Reporting, June 11, 1996	Approved*	
Concept No. 1	Objectives of Federal Financial Reporting, September 2, 1993	Final	
Concept No. 2	Entity and Display, June 6, 1995	Final	

*The Financial Accounting Standards Advisory Board has issued an exposure draft, "Amendments to Accounting For Property, Plant, and Equipment," February 13, 1998. The exposure draft contains proposed amendments to Standards No. 6 and No. 8.

Through FY 1997, agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01. A summary of the FY 1997 hierarchy follows:

- standards agreed to and published by the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States;
- requirements for the form and content of financial statements in OMB Bulletin No. 94-01, as amended by OMB Bulletin No. 97-01;

- accounting standards in agency accounting policy, procedures, or other guidance as of March 29, 1991; and
- accounting principles published by other authoritative sources.

Overview and Performance Measurements. We also reviewed the financial information in the Overview to the FY 1997 Fund Financial Statements. We did not find any instances in which the Overview was materially inconsistent with the Principal Statements. We have not audited the information in the Overview; therefore, we are not rendering an opinion. We did not review the data on performance measurements.

Review of Internal Controls. Our consideration of the internal controls included obtaining an understanding of significant policies and procedures and assessing the level of control risk relevant to all significant cycles, classes of transactions, or account balances. For those 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. For areas where internal controls were determined to be weak, we attempted to perform tests to determine the level of assurance that could be placed on those controls.

Our consideration of the internal controls would not necessarily disclose all matters that might be reportable conditions, and would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

Review of Compliance With Laws and Regulations. As part of obtaining reasonable assurance about whether the FY 1997 Fund Financial Statements were free of material misstatements, we reviewed compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by OMB and DoD. See Appendix E for a list of the laws and regulations we reviewed.

Methodology

Computer-Processed Data. To achieve the overall audit objective, we initially relied on computer-processed data obtained from the DNSC Master Inventory File (MIF). We assessed the reliability of the MIF data by reviewing the general controls at DNSC, comparing the MIF records to storage depot records, and testing inventories of the DNSC materials. To perform the inventory of DNSC materials, we used both statistical and judgmental samples. At inventory locations, we made comparisons between our physical inventory results, MIF information, and the storage depot records for the statistical sample items. At those locations, we also observed judgmental samples of other items and verified the existence of these items on the MIF. The MIF data that we audited were generally reliable.

Statistical Sampling Methods. The Quantitative Methods Division, Office of the Inspector General for auditing, DoD, developed the statistical sampling plan for this audit. That work included statistically selecting the locations and the inventory line items at each location. In addition, the Army Corps of Engineers (the Corps) provided assistance with measuring sample selections of materials in bulk storage, as these materials were not readily countable. We have not evaluated the results of the sample because the results of the bulk commodities measurements from the Corps were delayed. However, for the 42 countable items we physically inventoried, significant discrepancies existed for 2 items. We found significant differences between the MIF and depot records for an additional three sample items, two of which were bulk commodities measured by the Corps. Finding D describes the discrepancies found.

Audit Period and Locations. We conducted this audit from October 1997 through April 1998 at the DNSC and its storage locations and at the DFAS Columbus Center.

Representation Letters. We received a management representation letter from the Director, DLA, and a legal representation letter from the General Counsel, DLA. Both letters stated that officials had no knowledge of any matters that would have a material effect on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements. See Appendix D of the final report for the representation letters.

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

Management Control Program

DoD Directive 5010.38 and DoD Instruction 5010.40 require DoD organizations to implement a comprehensive system of internal controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DNSC internal controls as they relate to the FY 1997 Fund Financial Statements. Specifically, we reviewed DNSC internal controls over the recording, accounting, and reporting of financial information resulting from DNSC operations during FY 1997.

Adequacy of Management Controls. The Fund internal controls were generally adequate. However, a material internal control weakness was identified in the reporting of accounts receivable (Finding B). The official responsible for DLA management controls will receive a copy of the report.

Adequacy of Management's Self-Evaluation. The DFAS Annual Statement of Assurance for FY 1997 identified weaknesses in the Standard Army Financial System (STANFINS) Redesign Subsystem One, which DFAS uses to process DNSC cash receipts and disbursements. The FY 1997 Annual Statements of Assurance of DLA, DNSC, and the DFAS Columbus Center did not identify any material weaknesses in controls over DNSC operations.

Appendix B. Prior Audit Reports

During the last 5 years, several reports were issued that relate to the Fund financial statements and DNSC accounting policies and practices.

General Accounting Office Letter Report No. NSIAD-97-30 (OSD Case No. 1200), "Disposal of Excess Zinc," November 7, 1996. This audit was performed in response to a Congressional request resulting from a dispute between the American Zinc Association and the Federal Government. The dispute concerned the Government's basis for its interpretation of the statutory phrase "usual markets" as applied to the zinc sales program, and DoD efforts to minimize disruption of the zinc market. The General Accounting Office found that the statute did not define "usual markets" and agreed with the DNSC interpretation that the phrase refers to the total U.S. market for all grades of zinc, not only the grades sold by DNSC. The report also stated that DNSC had procedures for selling zinc without unduly disrupting the zinc market. The report contained no recommendations.

General Accounting Office Report No. AIMD-95-35R (OSD Case No. 9842), "Stockpile Fund," December 16, 1994. The auditors reviewed accounting policies and practices for cash and noncash transactions. The report stated that cash and noncash transactions were not separately identified in the FY 1993 Fund Financial Statements and the annual Strategic and Critical Materials Report to the Congress for FY 1993. Also, the FY 1993 Fund Financial Statements did not separately disclose all amounts included in the Net Position of the Fund, as prescribed by OMB. Additionally, the report stated that DNSC was not in compliance with Public Law 100-440, "Treasury, Postal Service, and General Government Appropriations Act, 1989," September 22, 1988, section 518, because the Fund used part of the estimated $215.8 million appropriated to the Fund before January 1, 1985, on contracts involving in-kind exchanges that did not meet the requirements of Public Law 100-440. The Fund was required to use, before January 1, 1998, all funds authorized and appropriated to evaluate, test, relocate, upgrade, or purchase stockpile materials. The report contains no recommendations.

Inspector General, DoD, Report No. 97-176, "Internal Controls and Compliance With Laws and Regulations for the National Defense Stockpile Transaction Fund Financial Statements for FY 1996," June 25, 1997. We rendered a qualified opinion on the financial statements for FY 1996 because we were unable to compare the FY 1996 financial statement balances to the FY 1995 balances. The audit did not disclose any material internal control weaknesses. Management control problems continued to exist in collecting delinquent accounts receivable and related interest charges, and the recording and reporting of interest revenue due to the U.S. Treasury. Management generally complied with laws and regulations related to the accuracy of financial statements. However, DNSC did not comply with guidance for U.S. Treasury interest receivable; allowances for uncollectible accounts; and accounting for fixed assets, accrued annual leave, and pension expense. DLA management concurred with all recommendations, stating that interest receivable would be included in the FY 1997 Fund Financial Statements. DFAS provided comments after the final report was issued, concurring with all recommendations and describing corrective actions that would be implemented. As of March 1998, DNSC and the DFAS Columbus Center had made minimal progress in implementing adequate collection procedures. The recording of interest charges was corrected, and interest receivable was reported in the FY 1997 Fund Financial Statements. Except for the reporting of pension expenses, the reportable conditions in compliance with laws and regulations were corrected.

Inspector General, DoD, Report No. 96-190, "Internal Controls and Compliance With Laws and Regulations for the National Defense Stockpile Transaction Fund Financial Statements for FY 1995," June 28, 1996. We disclaimed an opinion on the financial statements because documentation was not available to support the value of inventory. The auditors did not find any material internal control weaknesses or lack of compliance with laws and regulations. However, the audit disclosed reportable internal control conditions in the accuracy of the Stockpile Materials inventory balance on the financial statements; in the collection of accounts receivable and related interest receivable; and in the recording and reporting of interest due to the U.S. Treasury. The audit also disclosed a reportable condition in the failure to comply with guidance for the form and content of financial statements. Management concurred with all recommendations, but had taken effective action only for the inventory balance of Stockpile Materials on the financial statements. Therefore, all other conditions were cited in the report on the audit of the FY 1996 Fund Financial Statements.

Inspector General, DoD, Report No. 93-139, "National Defense Stockpile Transaction Fund Financial Statements for FY 1992," June 30, 1993. We disclaimed an opinion on the financial statements because DLA could not provide documentation to support the value of inventory on the financial statements, and management did not provide the necessary management and legal representation letters. The audit did not disclose any reportable or material internal control weaknesses. The report stated that DNSC complied in all material respects with policies, laws, and regulations. The report did not contain any recommendations. Management concurred with all facts presented in the report.

Appendix C. Principal Statements, Footnotes to Principal Statements, and Audit Opinion

This appendix (a total of 32 pages) contains excerpts from the National Defense Stockpile Transaction Fund Chief Financial Officer Annual Financial Statement for FY 1997, dated March 1, 1998. Included are the Principal Statements, Footnotes to the Principal Statements, and the Audit Opinion. A complete set of the Chief Financial Officer Annual Financial Statement is available at the following Internet address: http://www.dtic.mil/comptroller/97afs/.

DEFENSE NATIONAL STOCKPILE TRANSACTION FUND

PRINCIPAL STATEMENTS

Principal Statements

Defense National Stockpile Transaction Fund
Statement of Financial Position
As of September 30, 1997
(Thousands)

ASSETS	1997	1996
1. Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$519,768	$290,712
(2) Investments, Net (Note 4)	0	0
(3) Accounts Receivable, Net (Note 5)	35	35
(4) Interest Receivable	0	0
(5) Advances and Prepayments	1,184	(749)
(6) Other Federal (Intragovernmental) (Note 6)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Investments (Note 4)	0	0
(2) Accounts Receivable, Net (Note 5)	278,539	285,021
(3) Credit Program Receivables/ Related Foreclosed Property, Net (Note 7)	0	0
(4) Interest Receivable, Net	0	0
(5) Advances and Prepayments	0	0
(6) Other Non-Federal (Governmental) (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Inventory, Net (Note 8)	0	0
e. Work in Process (Note 9)	0	0
f. Operating Materials/Supplies, Net (Note 10)	0	0
g. Stockpile Materials, Net (Note 11)	3,320,087	3,696,491
h. Seized Property (Note 12)	0	0
i. Forfeited Property, Net (Note 13)	0	0
j. Goods Held Under Price Support and Stabilization Programs, Net (Note 14)	0	0
k. Property, Plant and Equipment, Net (Note 15)	258	0
l. War Reserves	0	0
m. Other Entity Assets	0	0
n. Total Entity Assets	$4,119,871	$4,271,510
2. Non-Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$0	$0
(2) Accounts Receivable, Net (Note 5)	0	0
(3) Interest Receivable, Net	0	0
(4) Other (Note 6)	0	0

The accompanying notes are an integral part of these statements.

Department of Defense
Defense National Stockpile Transaction Fund
Statement of Financial Position
As of September 30, 1997
(Thousands)

ASSETS, Continued	1997	1996
2. Non-Entity Assets:		
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Receivable, Net (Note 5)	$0	$0
(2) Interest Receivable, Net	2,642	0
(3) Other (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Other Non-Entity Assets	0	0
e. Total Non-Entity Assets	$2,642	$0
3. Total Assets	$4,122,513	$4,271,510
LIABILITIES		
4. Liabilities Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$60,632	$59,515
(2) Interest Payable	0	0
(3) Debt (Note 16)	0	0
(4) Other Federal (Intragovernmental) Liabilities (Note 17)	51,161	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	$2,759	7,979
(2) Accrued Payroll and Benefits		
(a) Salaries and Wages	53	0
(b) Annual Accrued Leave	0	0
(c) Severance Pay and Separation Allowance	0	0
(3) Interest Payable	0	0
(4) Liabilities for Loan Guarantees (Note 7)	0	0
(5) Lease Liabilities (Note 18)	0	0
(6) Pensions and Other Actuarial Liabilities (Note 19)	0	0
(7) Other Non-Federal (Governmental) Liabilities (Note 17)	4,800	1,558
c. Total Liabilities Covered by Budgetary Resources:	$119,405	$69,052

The accompanying notes are an integral part of these statements.

Department of Defense
Defense National Stockpile Transaction Fund
Statement of Financial Position
As of September 30, 1997
(Thousands)

LIABILITIES, Continued	1997	1996
5. **Liabilities Not Covered by Budgetary Resources:**		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$0	$0
(2) Debt (Note 16)	0	0
(3) Other Federal (Intragovernmental) Liabilities (Note 17)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	0	0
(2) Debt (Note 16)	0	0
(3) Lease Liabilities (Note 18)	0	0
(4) Pensions and Other Actuarial Liabilities (Note 19)	0	0
(5) Other Non-Federal (Governmental) Liabilities (Note 17)	496	0
c. **Total Liabilities Not Covered by Budgetary Resources**	$496	$0
6. **Total Liabilities**	$119,901	$69,052
NET POSITION (Note 20)		
7. **Balances:**		
a. Unexpended Appropriations	$3,980	$0
b. Invested Capital	3,377,691	3,536,106
c. Cumulative Results of Operations	621,437	666,352
d. Other	0	0
e. Future Funding Requirements	(496)	0
f. **Total Net Position**	$4,002,612	$4,202,458
8. **Total Liabilities and Net Position**	$4,122,513	$4,271,510

The accompanying notes are an integral part of these statements.

Principal Statements

Defense National Stockpile Transaction Fund
Statement of Operations and Changes in Net Position
For the Period Ended September 30, 1997
(Thousands)

	1997	1996
REVENUES AND FINANCING SOURCES		
1. Appropriated Capital Used	$0	$0
2. Revenues from Sales of Goods and Services		
a. To the Public	499,918	365,982
b. Intragovernmental	29,432	54,267
3. Interest and Penalties, Non-Federal	2,945	0
4. Interest, Federal	0	0
5. Taxes (Note 21)	0	0
6. Other Revenues and Financing Sources (Note 22)	0	1,442
7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies	(301)	0
8. Total Revenues and Financing Sources	$531,994	$421,691
EXPENSES		
9. Program or Operating Expenses (Note 23)	$56,315	$59,360
10. Cost of Goods Sold (Note 24)		
a. To the Public	365,701	141,543
b. Intragovernmental	7,782	14,222
11. Depreciation and Amortization	0	0
12. Bad Debts and Writeoffs	232	120
13. Interest		
a. Federal Financing Bank/Treasury Borrowing	0	0
b. Federal Securities	0	0
c. Other	0	0
14. Other Expenses (Note 25)	0	0
15. Total Expenses	$430,030	$215,245
16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items	$101,964	$206,446
17. Plus (Minus) Extraordinary Items (Note 26)	0	0
18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	$101,964	$206,446

The accompanying notes are an integral part of these statements.

Department of Defense
Defense National Stockpile Transaction Fund
Statement of Operations and Changes in Net Position
For the Period Ended September 30, 1997
(Thousands)

EXPENSES, Continued	1997	1996
19. Net Position, Beginning Balance, as Previously Stated	$4,202,458	$4,270,691
20. Adjustments (Note 27)	(18,510)	(123,784)
21. Net Position, Beginning Balance, as Restated	$4,183,948	$4,146,907
22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	101,964	206,446
23. Plus (Minus) Non Operating Changes (Note 28)	(283,300)	(150,895)
24. Net Position, Ending Balance	$4,002,612	$4,202,458

The accompanying notes are an integral part of these statements.

Department of Defense
Defense National Stockpile Transaction Fund
Statement of Cash Flows
For the Period Ended September 30, 1997
(Thousands)

	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES		
1. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	$101,964	$206,446
Adjustments Affecting Cash Flow:		
2. Appropriated Capital Used	0	0
3. Decrease (Increase) in Accounts Receivable	3,840	(56,376)
4. Decrease (Increase) in Other Assets	374,471	254,179
5. Increase (Decrease) in Accounts Payable	(4,103)	(9,393)
6. Increase (Decrease) in Other Liabilities	54,456	1,027
7. Depreciation and Amortization	0	0
8. Other Unfunded Expenses	(51,161)	0
9. Other Adjustments	(19,411)	(123,784)
10. Total Adjustments	$358,092	$65,653
11. Net Cash Provided (Used) by Operating Activities	$460,056	$272,099
CASH FLOWS FROM INVESTING ACTIVITIES		
12. Sale of Property, Plant and Equipment	$0	$0
13. Purchase of Property, Plant and Equipment	0	0
14. Sale of Securities	0	0
15. Purchase of Securities	0	0
16. Collection of Loans Receivable	0	0
17. Creation of Loans Receivable	0	0
18. Other Investing Cash Provided (Used)	0	0
19. Net Cash Provided (Used) by Investing Activities	$0	$0
CASH FLOWS FROM FINANCING ACTIVITIES		
20. Appropriations (Current Warrants)	$0	$0
21. Add:		
a. Restorations	0	0
b. Transfers of Cash from Others	0	0
22. Deduct:		
a. Withdrawals	0	0
b. Transfers of Cash to Others	231,000	150,000
23. Net Appropriations	($231,000)	($150,000)

The accompanying notes are an integral part of these statements.

Department of Defense
Defense National Stockpile Transaction Fund
Statement of Cash Flows
For the Period Ended September 30, 1997
(Thousands)

CASH FLOWS FROM FINANCING ACTIVITIES, Continued	1997	1996
24. Borrowing from the Public	$0	$0
25. Repayments on Loans to the Public	0	0
26. Borrowing from the Treasury and the Federal Financing Bank	0	0
27. Repayments on Loans from the Treasury and the Federal Financing Bank	0	0
28. Other Borrowings and Repayments	0	0
29. Net Cash Provided (Used) by Financing Activities	($231,000)	($150,000)
30. Net Cash Provided (Used) by Operating, Investing and Financing Activities	$229,056	$122,099
31. Fund Balance with Treasury, Cash, and Foreign Currency, Beginning	290,712	168,613
32. Fund Balance with Treasury, Cash, and Foreign Currency, Ending	$519,768	$290,712

Supplemental Disclosure of Cash Flow Information:	1997	1996
33. Total Interest Paid	$0	$0

Supplemental Schedule of Financing and Investing Activity:	1997	1996
34. Property and Equipment Acquired Under Capital Lease Obligations	$0	$0
35. Property Acquired Under Long-Term Financing Arrangements	$0	$0
36. Other Exchanges of Non-cash Assets or Liabilities	$0	$0

The accompanying notes are an integral part of these statements.

DEFENSE NATIONAL STOCKPILE TRANSACTION FUND

FOOTNOTES TO THE PRINCIPAL STATEMENTS

Footnotes

DEFENSE NATIONAL STOCKPILE TRANSACTION FUND FINANCIAL OPERATIONS NOTES TO THE PRINCIPAL STATEMENTS AS OF SEPTEMBER 30, 1996

Note 1. Significant Accounting Policies

A. Basis of Presentation:

These financial statements have been prepared to report the financial position and results of operations of the Defense Logistics Agency (DLA) National Defense Stockpile Transaction Fund, (the T-Fund) as required by the Chief Financial Officers (CFO) Act of 1990. They have been prepared from the accounting records of the T-Fund in accordance with the hierarchy of accounting standards as prescribed by the Federal Accounting Standards Advisory Board (FASAB), OMB Bulletin 94-01 and supplemental DoD guidance. The accounting standards prescribed by the FASAB, in the DoD Accounting Manual (DoD 7220.9-M) and in the Financial Management Regulation (DoD 7000.14-R) were followed, as appropriate. To the extent that guidance is not provided by one of these standards, the T-Fund accounts for transactions in accordance with guidance promulgated by the GAO, OMB, Department of Treasury, and commercial Generally Accepted Accounting Principles. These statements differ from the T-Fund financial reports prepared to monitor and control the use of budgetary resources.

B. Reporting Entity:

The Defense Logistics Agency (DLA) is a combat support agency responsible for worldwide logistics support throughout the Department of Defense. The primary focus of the DLA is to support the war fighter, and to provide relief efforts during times of national emergency. The DLA Defense National Stockpile Center (DNSC) administers the acquisition, storage, management, and disposal of the Nation' s strategic and critical inventory of materials essential to the Military and industrial requirements of the United States. The T-Fund is a revolving fund that accounts for sources necessary to procure and dispose strategic commodities. The appropriation symbol is 97X4555.5145.

The CFO Act requires the T-Fund, as a revolving fund, to provide audited financial statements. Fiscal year 1997 represents the fifth year that the T-Fund has prepared financial statements as required by the CFO Act.

C. Budgets and Budgetary Accounting:

The T-Fund receives an apportionment from the Office of Management and Budget for the operation and acquisition programs.

D. Basis of Accounting:

Transactions are recorded on a accrual accounting basis and a budgetary basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. All known intrafund balances have been eliminated.

E. Revenues and Other Financing Sources:

Revenues and financing sources for the T-Fund consist of cash proceeds from the disposal of excess commodities and related services provided to the customers.

F. Accounting for Intra-governmental Activities:

DLA, as an agency of the Federal government, interacts with, and is dependent upon, other financial activities of the government as a whole. As a result, these financial statements do not reflect the results of all financial decisions applicable to DLA as though the agency were a stand alone entity.

For example, DLA's proportionate share of the public debt and related expenses of the Federal Government are not included in these financial statements because debt and related interest costs are not apportioned to Federal agencies. Financing for the construction of DoD facilities is obtained through appropriations from the Congress. To the extent that this financing may have been ultimately obtained through the issuance of public debt, interest costs have not been capitalized since the Treasury Department does not allocate interest costs to the benefiting agencies.

Finally, the T-Fund's civilian employees participate in the Civil Service Retirement System (CSRS) and Federal Employees Retirement System (FERS). The following is a list of personnel benefits for FY 1997:

Life Insurance	$23,286
Health Benefits	593,149
CSRS & FERS	1,021,405
Social Security	510,727
Thrift Plan	187,081
Benefits for Former Personnel	117,409

G. Funds with the U.S. Treasury and Cash:

The funds with the U.S. Treasury represent the balances as of 30 September 1997. Cash receipts and disbursements affect the available balances.

H. Foreign Currency:

Not applicable.

I. Accounts Receivable:

Allowances for uncollectible accounts are established. Sales and disposals are recorded as receivable at the time the sales agreement is issued and the material is removed from Inventory. Storage charges are assessed and billed if the purchaser does not pickup the material within the agreed upon time frame.

During fiscal year 1997, DNSC recognized a prior period adjustment of approximately $17 million to correct prior year' s defaulted and other incorrect revenue posted in accounts receivable.

J. Loans Receivable:

Not applicable.

K. Inventories:

The financial inventory balance for the stockpile materials is maintained on a historical cost basis, which includes acquisition cost plus any fees, such as testing, upgrading, and transportation expenses. It is reported as Stockpile materials in the Principal Statements.

When the mission of the Stockpile was transferred to the DoD from GSA in 1988, the DoDIG audited the physical inventory records and historical values of the inventory were established. The establishment of historical costs was necessary at that time because the original records of some of the purchases dated back to the 1950's and were no longer available. The market value of the material as of 30 September 1997 is estimated to be $5.4 billion.

L. Investments in U.S. Government Securities:

Not applicable.

M. Property and Equipment:

After further review, the National Stockpile Transaction Fund has determined it has no equipment which meets the current DoD capitalization threshold, but does have some equipment which meets previous capitalization thresholds and meets the requirements for these statements. In Fiscal Year 1998 we anticipate the acquisition of equipment that will meet the criteria and will be reported accordingly in the FY 98 statements.

N. Prepaid and Deferred Charges:

Not applicable.

O. Leases:

The T-Fund is committed to operating leases and rental agreements. Generally, these leases and agreements are for the rental of equipment, space and operating facilities. Payments under these operating leases are expensed as incurred.

P. Contingencies:

The T-Fund may be party to various legal and administrative claims and actions. In management's opinion, the resolution of these actions will not materially affect the T-Fund operations or financial position. Therefore, no contingent liabilities have been recognized in the Statement of Financial Position.

Q. Accrued Leave:

Civilian annual leave is accrued as earned, and accrued hours are reduced as leave is taken. Sick leave and other types of nonvested leave are expensed as taken.

R. Equity:

Equity consists of invested capital, appropriated capital-grants and cumulative result of operations. Invested capital, as presented in the Statement of Financial Position, represents the value of the DNSC' s capital assets as reported at historical or actual costs. Increases to invested capital are recorded when capital assets are acquired. Decreases occur as capital assets are depreciated or transferred. Appropriated capital represents the remaining balance of grants authorized by Congress and administered by the DNSC.

Cumulative results of operations are the excess of revenues over expenses, less refunds to customers.

S. Aircraft/Ship Crashes:

Not applicable.

T. Treaties for Use of Foreign Bases:

Not applicable.

U. Comparative Data

The financial statements present fiscal year 1996 and 1997 amounts. For fiscal year 1996, the financial statements were audited and were found to present fairly, in all material respects, the financial position of the Fund as of September 30, 1996, and did not identify any material weaknesses relating to the Fund' s activities. A qualified opinion was issued based on the lack of a complete audit performed on the fiscal year 1995 financial statements.

V. Restatement of Prior Year Principal Statements

Not applicable.

W. Unpaid Obligations and Undelivered Orders

The T-Fund is obligated for goods and services that have been ordered but not yet received. Total undelivered orders amounted to $5,979,700.54 as of September 30, 1997.

Note 2. Fund Balances with Treasury

A. Business Operations Fund (USD(C)) and All Other Funds and Accounts:

	Entity Assets				
	Trust Funds	Revolving Funds	Appropriated Funds	Other Fund Types	Total
Unobligated Balance Available:					
Available	$0	$733,989	$0	$0	$733,989
Restricted	0	51,797	0	0	51,797
Reserve For Anticipated Resources	(0)	(0)	(0)	(0)	(0)
Obligated (but not expensed)	0	(266,018)	0	0	(266,018)
Unfunded Contract Authority	(0)	(0)	(0)	(0)	(0)
Unused Borrowing Authority	(0)	(0)	(0)	(0)	(0)
Treasury Balance	$0	$519,768	$0	$0	$519,768

B. Business Operations Fund Activities Below USD(C) Level:

Not applicable.

C. All Funds and Accounts:

	Entity Assets	
	Funds Collected	Funds Disbursed
Beginning Balance	$290,712	$0
Transfers of Cash to Others	0	231,000
Transfers of Cash from Others	0	0
Funds Collected	514,896	0
Funds Disbursed	(0)	54,840
Ending Balance	$805,608	$285,840

D. **Other Information:**

The amount reported on the General Ledger Trial Balance for Defense National Stockpile is over stated by $45,914.60 and is no longer included in the Treasury Balance shown above. This amount represents transactions by others that have been reported to Treasury but have not reached the accounting office responsible for inclusion in the Trial Balance. Restriction of funds is the amount of monies collected but not yet transferred to the Treasury under P.L. 104-201.

Note 3. Cash Foreign Currency and Other Monetary Assets

Not applicable.

Note 4. Investments, Net

Not applicable.

Note 5. Accounts Receivable, Net

		(1) Allowance Amount Due	(2) Allowance For Estimated Uncollectibles	(3) Method Used	(4) Amount Due
A.	**Entity Receivables:**				
	Intragovernmental	$35	0		35
	Governmental	278,768	229		278,539
B.	**Non-Entity Receivables:**				
	Intragovernmental	0	0		0
	Governmental	0	0		0

C. **Other Information:** Not applicable.

Note 6. Other Federal (Intragovernmental) and Non-Federal (Governmental) Assets

Not applicable.

Note 7. Loans and Loan Guarantees, Non-Federal Borrowers

Not applicable.

Note 8. Inventory, Net

Not applicable.

Note 9. Work in Process

Not applicable.

Note 10. Operating Materials and Supplies (OM&S), Net

Not applicable.

Footnotes

Note 11. Stockpile Materials Net

	(1) Stockpile Materials Amount	(2) Allowance For Losses	(3) Stockpile Materials Net	(4) Valuation Method
A. Stockpile Material:				
(1) Held for Sale	$1,404,419	$0	$1,404,419	Historical
(2) Held in Reserve for Future Sale	1,915,668	0	1,915,668	Historical
Total	$3,320,087	$ 0	$3,320,087	

B. Restrictions on Stockpile Materials and Supplies:

There are several restrictions on the use of the materials. The quantities to be stockpiled are required to be sufficient to sustain the U. S. for a period of not less than three years during a national emergency (including a sustained conventional global war of indefinite duration). The required stockpile levels can only be changed by law through a Presidential proposal in the Annual Material Plan submitted to Congress.

Except for disposals made under the following situations, disposals cannot be made from the stockpile

- Necessary upgrading, refining or processing
- Necessary rotation to prevent deterioration
- Determination as excess and of potential financial loss if not disposed
- By order of the President and/or authorized by law

C. Other Information:

The estimated market value of the total inventory as of September 30, 1997, is $5.380 billion. The financial statements report the recorded historical cost in accordance with the lower of cost or market principal.

Note 12. Seized Property

Not applicable.

Note 13. Forfeited Property, Net

Not applicable.

Note 14. Goods Held Under Price Support and Stabilization Programs, Net

Not applicable.

Note 15. Property, Plant, and Equipment

	(1) Depreciation Method	(2) Service Life	(3) Acquisition Value	(4) Accumulated Depreciation	(5) Net Book Value
Classes of Fixed Assets					
A. Land			$0	$0	$0
B. Structures, Facilities, & Leasehold Improvements			0	0	0
C. Military Equipment			0	0	0
D. ADP Software			0	0	0
E. Equipment	SL	1-5	4,806	4,548	258
F. Assets Under Capital Lease			0	0	0
G. Other			0	0	0
H. Natural Resources			0	0	0
I. Construction-in-Progress			0	0	0
Total			4,806	4,548	258

*Key:

Depreciation Methods	Range of Service Life	
SL - Straight Line	1-5	1 to 5 years
DD - Double-Declining Balance	6-10	6 to 10 years
SY - Sum of the Years' Digits	11-20	11 to 20 years
IN - Interest (sinking fund)	>20	Over 20 years
PR - Production (activity or use method)		
OT - Other (describe)		

Note 16. Debt

Not applicable.

Footnotes

Note 17. Other Liabilities

A. Other Liabilities Covered by Budgetary Resources:

	Non-Current Liabilities	Current Liabilities	Total
1. Intragovernmental			
a. P.L. 104-201	$0	$51,161	$51,161
b.__________			
c.__________			
	$0	$51,161	$51,161

	Non-Current Liabilities	Current Liabilities	Total
2. Governmental			
a. Bid Deposits	$0	$4,800	$4,800
b.__________			
c.__________			
	$0	$4,800	$4,800

B. Other Information:

In FY 97 DNSC collected $51,161 million more than the $81.0 million that was required to be transferred by P.L. 102-201. The $51,161 million remaining in the fund is a liability for future transfers.

C. Other Liabilities Not Covered by Budgetary Resources:

	Non-Current Liabilities	Current Liabilities	Total
1. Intragovernmental			
a.	$0	$0	$0
b.__________			
c.__________			
	$0	$0	$0

	Non-Current Liabilities	Current Liabilities	Total
2. Governmental			
a. Accrued Annual Leave-Civilian	$0	$496	$496
b.__________			
c.__________			
	$0	$496	$496

Note 18. Leases

Not applicable.

Note 19. Pensions and Other Actuarial Liabilities

Not applicable.

Note 20. Net Position

	Revolving Funds	Trust Funds	Appropriated Funds	Total
A. Unexpended Appropriations:				
(1) Unobligated,				
a. Available	$0	$0	$0	$0
b. Unavailable	0	0	0	0
(2) Undelivered Orders	3,980	0	0	3,980
B. Invested Capital	3,377,691	0	0	3,377,691
C. Cumulative Results of Operations	621,437	0	0	621,437
D. Other	0	0	0	0
E. Future Funding Requirements	(496)	(0)	(0)	(496)
F. Total	$4,002,612	$0	$0	$4,002,612

G. Other Information:

The amount listed in Undelivered Orders is the amount unexpended for Congressionally appropriated grants.

Note 21. Taxes

Not applicable.

Footnotes

Note 22. Other Revenues and Financing Sources

A. Other Revenues and Financing Sources	1997	1996
1.	0	$1,442
2.	0	0
3.	0	0
Total	0	$1,442

B. Other Information:

In FY 1996 income was reported on this line in error. This amount includes charges for services performed. In FY 1997 the corresponding amount was included as normal revenue.

Note 23. Program or Operating Expenses

	1997	1996
A. Operating Expenses by Object Classification:		
(1) Personal Services and Benefits	$14,985	$15,810
(2) Travel and Transportation	1,336	1,259
(3) Rental, Communication and Utilities	19,799	18,249
(4) Printing and Reproduction	9	5
(5) Contractual Services	13,562	14,408
(6) Supplies and Materials	1,409	885
(7) Equipment not Capitalized	1,525	265
(8) Grants, Subsidies and Contributions	3,679	8,470
(9) Insurance Claims and Indemnities	0	0
(10) Other (describe):		
(a) County Taxes	1	9
(b) Interest Paid to Contractors	10	
(11) Total Expenses by Object Class	$56,315	$59,360

B. Operating Expenses by Program:

Not applicable.

C. Other Information:

Operating expenses are not available by program.

Note 24. Cost of Goods Sold A, B, or C as appropriate.

C. Cost of Goods Sold from Inventory (using Historical Cost):

(1) Beginning Inventory	$3,696,491
Plus: Purchases at Cost	0
Plus: Inventory Gains	431
Minus: Inventory Losses	(518)
Minus: Inventory transferred at no cost	(901)
Minus: Silver shipped but not yet sold	(1,933)
(2) Less: Ending Inventory	(3,320,087)
Cost of Goods Sold	373,483

D. The cost of goods sold shown above includes $1,933 thousand for silver shipped to the U.S. Mint and unsold as of September 30, 1997.

Note 25. Other Expense

Not applicable.

Note 26. Extraordinary Items

Not applicable.

Note 27. Prior Period Adjustments

A. Prior Period Adjustments:

(1)Defaulted Contracts/Other PY Adjustments	($18,510)
(2)__________	0
Total	($18,510)

B. Other Information:

Not applicable.

Note 28. Non-Operating Changes - (Transfers and Donations)

	1997	1996
B. Decreases:		
(1) Transfers-Out:		
(a)U.S Army	($50,000)	($50,000)
(b)U.S. Air Force	(50,000)	(50,000)
(c)U.S. Navy	(50,000)	(50,000)
(d)U.S. Treasury – P.L. 104-201	(81,000)	
(2) Non Operating Liability – P.L. 104-201	(51,161)	
(3) Other Decreases	(1,139)	(895)
(4) Total Decreases	0	0
C. Net Non-Operating Changes (Transfers):	($283,300)	($150,895)

D. Other Information:

DNSC transferred Titanium to the U.S. Army without reimbursement, per P.L 104-106, with an inventory value of $901 thousand. DNSC recorded equipment not previously recorded on the books as net of depreciation, $258. In addition there was an unfunded annual leave accrual of $496. These three transactions (901+496-258) make up the $1,139 thousand in "Other Decreases" above.

Note 29. Intrafund Eliminations (in thousands)

Schedule A:

Not applicable.

Schedule B:

Not applicable.

Schedule C:

Not applicable.

Schedule D:

Selling Activity:	Reimb. Source Code	Accounts Receivable	Revenue	Unearned Revenue	Collections
Defense National Stockpile	F	$0	$21,276		$21,276
Total		$0	$21,276		$21,276

Customer Activity:	Accounts Payable	Expenses	Advances	Disbursements
Department of the Treasury				
(Bureau of the Mint) (T.I. 20)	$21,276	$0	$0	$21,276
Total	$21,276	$0	$0	$21,276

This represents sale of silver coins by the Bureau of the Mint for the Defense National Stockpile.

Note 30. Contingencies

Not applicable.

Note 31. Other Disclosures

Operating leases for FY 1997 were $18.3 million. Proposed operating lease amounts through FY 2002 as proposed in the POM submitted in FY 1997 with corrections to FY 1998 and FY 1999 from the FY 1999 BES in millions are:

FY 1998	$20.0
FY 1999	19.5
FY 2000	16.7
FY 2001	14.1
FY 2002	13.7

DEFENSE NATIONAL STOCKPILE TRANSACTION FUND

FINANCIAL STATEMENTS

AUDIT OPINION

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

February 27, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Disclaimer of Opinion on the National Defense Stockpile Transaction Fund Financial Statements for FY 1997 (Project No. 8FH-2004)

The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibilities of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. Fund managers are responsible for establishing and maintaining an internal control structure and for complying with laws and regulations applicable to the National Defense Stockpile Transaction Fund (the Fund). Our responsibility is to render an opinion on the financial statements based on our audit, and to determine whether internal controls are adequate and whether the Fund complied with applicable laws and regulations.

Disclaimer of Opinion. We were unable to render an opinion on the National Defense Stockpile Transaction Fund Financial Statements for FY 1997 because we could not verify the inventory valuation and confirm the accounts receivable. We were unable to verify the inventory valuation because the results of bulk commodities measurements by the Army Corps of Engineers (the Corps) were not available by the date this opinion was issued. The Corps results were late because of difficulties with selecting the statistical sample and scheduling visits to sample sites by Corps personnel, subcontractors, and auditors, and because the opinion for this fiscal year was required to be issued earlier than in previous years. Because of the lack of data on bulk commodities, which account for about 39 percent of Stockpile materials, we were unable to evaluate and project the results of the entire Stockpile materials sample. Therefore, we were unable to determine whether the on-hand quantities of the Stockpile materials (80 percent of total assets) were accurate. In addition, we were unable to render an opinion on the Accounts Receivable (7 percent of total assets). We attempted to confirm the Accounts Receivable balances as of September 30, 1997. However, we have received responses from only 60 percent of the customers, and 42 percent of the responses contained errors between the Government's and customer's balances.

Accounting Principles. The Fund's financial statements for FYs 1997 and 1996 were to be prepared in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. These Bulletins incorporate the Statements of Federal Financial Accounting Concepts and Standards recommended by the Federal Accounting Standards Advisory Board, which are approved by the Secretary of the Treasury; the

Director, OMB; and the Comptroller General of the United States. Footnote 1 of the Fund's financial statements discusses the significant accounting policies that the Defense National Stockpile Center followed in preparing the financial statements.

Internal Controls. We reviewed the internal control structure of the Fund and obtained an understanding of the internal control policies and procedures. In addition, we reviewed the implementation of the management control program by the Fund managers. We performed applicable tests of the internal control structure to determine whether the controls were effective and working as designed.

The internal control structure was effective in accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements were free of material misstatements. However, management needs to improve internal controls over the recording and collection of accounts receivable. The Annual Statements of Assurance of the Defense Logistics Agency and the Defense Finance and Accounting Service Columbus Center did not identify any material weaknesses related to Fund activities.

Compliance With Laws and Regulations. We assessed compliance with laws and regulations related to the financial statements. Management generally complied with the laws and regulations. None of the compliance issues identified during our work would have a material impact on the financial statements. One compliance issue was the failure to report a liability for Pensions and Other Actuarial Liabilities, which is contrary to guidance in the OMB Bulletin No. 94-01. In addition, under the Federal Financial Management Improvement Act of 1996 and OMB Bulletin No. 93-06, Addendum 1, "Audit Requirements for Federal Financial Statements," January 16, 1998, our work disclosed that financial management systems did not comply with Federal financial management system requirements; applicable Federal accounting standards; and the U.S. Government Standard General Ledger at the transaction level.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Appendix D. Management and Legal Representation Letters

This appendix, a total of 3 pages, consists of the management and legal representation letters for the FY 1997 National Defense Stockpile Transaction Fund Financial Statements.

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

IN REPLY REFER TO FOX

MAR 31 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD

SUBJECT: Management Representation Letter for the National Defense Stockpile Transaction Fund FY 1997 Financial Statements

For the purpose of expressing an opinion on whether the cited financial statements are presented fairly and in accordance with generally accepted accounting principles and Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, I confirm, to the best of my knowledge and belief, the following representations:

- o I am responsible for the fair presentation of the financial statements in accordance with generally accepted accounting principles and OMB Bulletin 94-01.
- o I have made available to you all financial records and related data.
- o I have no plans or intentions, other than any of those previously disclosed to you, that may materially affect the carrying value or classification of assets and liabilities.
- o I have no knowledge of irregularities involving management or employees who have significant roles in the internal control structure that are not a matter of public record.
- o I have no knowledge of other employees being involved in irregularities that could materially affect the financial statements that are not a matter of public record.
- o I have not received communications from regulatory agencies or auditors concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements that are not a matter of public record.
- o Related third-party transactions and related amounts receivable or payable of interested participants, including assessments, loans, and guarantees, are not applicable.
- o I have no knowledge of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency that are not a matter of public record.

- o There are no other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies," March 1975.

- o There are no unasserted claims or assessments that our legal representatives have advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board Statement No. 5.

- o I have no knowledge of material transactions that have not been properly recorded in the accounting records underlying the financial statements that are not a matter of public record.

- o Provisions, for material amounts, have been made to reduce excess or obsolete inventories to their estimated net realizable value.

- o To my knowledge, the Federal Government has satisfactory title to all reported assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral.

- o Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of normal requirements or at prices in excess of the prevailing market prices.

- o I have no knowledge of noncompliance with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

- o I have no knowledge of events that have occurred after the balance sheet date that would require adjustment to or disclosure in the financial statements that have not been previously identified on the statements.

Henry T. Glisson

HENRY T. GLISSON
Lieutenant General, USA
Director

Linda J. Furiga

LINDA J. FURIGA
Comptroller

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

IN REPLY REFER TO GC

March 1, 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
OFFICE OF THE INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: National Defense Stockpile Transaction Fund Financial Statement Audit FY 1997

This responds to the annual requirement for a legal representation regarding the audit of the National Defense Stockpile Transaction Fund FY 1997 financial statements.

I have no knowledge of any material claims, liens, loss contingencies, assessments or unasserted claims involving the National Defense Stockpile Transaction Fund for FY 1997 and to date of this memorandum.

It is my understanding that the level of materiality for this representation is limited to $100 million.

BRUCE W. BAIRD
General Counsel

Appendix E. Laws and Regulations Reviewed

Title 50, United States Code, section 98 *et seq.*, "Strategic and Critical Materials Stockpiling Act", December 4, 1987

Public Law 104-329, "United States Commemorative Coin Act of 1996," October 20, 1996

Public Law 104-201, "National Defense Authorization Act for Fiscal Year 1997," September 23, 1996

Public Law 104-208, "Federal Financial Management Improvement Act of 1996," September 8, 1996

Public Law 104-304, "Debt Collection Improvement Act of 1996," April 25, 1996

Public Law 104-106, "National Defense Authorization Act for Fiscal Year 1996," February 10, 1996

Public Law 103-356, "Federal Financial Management Act of 1994," October 13, 1994

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 97-255, "Federal Managers' Financial Integrity Act of 1982," September 8, 1982

OMB Bulletin No. 98-04, "Addendum to OMB Bulletin No. 93-06," January 16, 1998

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," October 27, 1993

Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995

Statement of Federal Financial Accounting Standards No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," May 10, 1996

Dod Regulation 7000.14-R, "DoD Financial Management Regulation," volume 6, "Reporting Policy and Procedures," February 1996

Dod Regulation 7000.14-R, "DoD Financial Management Regulation," volume 4, "Accounting Policy and Procedures," January 1995

Dod Regulation 7000.14-R, "DoD Financial Management Regulation," volume 10, "Contract Payment Policy and Procedures," June 1997

DoD Directive 5010.38, "Management Control Program," August 26, 1996

DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996

DoD 7220.9-M, "DoD Accounting Manual," October 1983

Appendix F. Report Distribution

Office of the Secretary of Defense

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

Department of the Army

Auditor General, Department of the Army

Department of the Navy

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

Department of the Air Force

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
  Director, Defense Finance and Accounting Service Columbus Center
Director, Defense Logistics Agency
Administrator, Defense National Stockpile Center

Non-Defense Federal Organizations and Individuals

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

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

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

Part III - Management Comments

Defense Logistics Agency Comments

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

IN REPLY REFER TO

MAY 28 1998

DDAI

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE

SUBJECT: Draft Report on Internal controls and compliance with Laws and Regulations for the FY97 National Defense Stockpile Transaction Fund Financial Statements, 8FH-2004.01

Enclosed are our comments to your request of 24 April 1998. Should you have any questions, please contact Mimi Schirmacher, 767-6263.

Encl

JEFFREY GOLDSTEIN
Chief (Acting), Internal Review Office

cc:
DNSC-DI
FO

SUBJECT: Internal Controls and Compliance With Laws and Regulations for the FY 1997 National Defense Stockpile Transaction Fund Financial Statements 8FH-2004.01

FINDING A. Collection of Accounts Receivable. The Fund's Delinquent accounts and interest receivable increased from $15.5 million reported on September 30, 1996 to $33.4 million on September 30, 1997. Of the $15.5 million reported on September 30, 1996, $10.7 million was still due on September 30, 1997. Our internal control and compliance reports for 1995 and 1996 reported the same condition and recommended improvement in the collection process and the writing off of accounts receivable. Collection of accounts receivable did not improve because DNSC did not finalize a new Concept of Operations between DNSC and DFAS Columbus Center, to improve collections of receivables, until late January 1998. Furthermore, DNSC and DFAS Columbus Center did not develop procedures for improving collections and writing off accounts receivable until February 1998. The amount of receivables increased because of the lack of action by DNSC and DFAS. Consequently, amounts legitimately due to the DoD may become uncollectable and lost.

DLA COMMENTS: Partially Concur. Although the delinquent accounts and interest receivables have increased, the issue is not debt collection. The cause of this condition is untimely contract administration. The delay in finalizing the Concept of Operations did not have a negative affect on this process. DNSC has experienced a substantial increase in contracting workload.

SALES	
FISCAL YEAR	NUMBER OF CONTRACTS
96	405
97	542
FY 98 as of 4/98	240 (projection 650)
ACQUISITIONS	
FISCAL YEAR	NUMBER OF CONTRACTS
96	199
97	278
FY 98 as of 4/98	188 (projection 310)

DNSC sent a team to DFAS Columbus Center in February 1998. As a result of that visit several recommendations for improved operations were made. DNSC management is in the process of evaluating these recommendations and will establish procedures to better accomplish Contract Administration. Improved contact administration should reduce the delinquent accounts receivable, however, until this is accomplished transferring all collections to DFAS Columbus will not correct the existing condition. In Finding B the administration should reduce the delinquent accounts receivable, however, until this is accomplished transferring all collections to DFAS Columbus will not correct the existing condition. In Finding B the auditors concluded that during the confirmation of Accounts Receivable the contractors balances were usually found to be correct. The improved Contract Administration will provide more accurate balances for delinquent accounts receivable. Once these accurate balances are established it would be effective for DFAS Columbus to assume the collection responsibility.

FINDING B: Reporting of Accounts Receivable. The $281.2 million in "Accounts Receivable" and "Interest Receivable" reported on the FY 1997 National Defense Stockpile Transaction Fund Financial Statements was overstated by approximately $9.7 million. This occurred because charges that should have been reversed by September 30, 1997, were not reversed, and cash received had not been posted as of September 30, 1997. Therefore, "Accounts Receivable" and the "Net Position" of the Fund were overstated by approximately $2.6 million in receivables that should have been reversed. In addition, "Accounts Receivable" were overstated by $7.1 million for cash received but not posted; "Fund Balance with Treasury" was understated by the same amount; and there was increased potential for problems in determining the amounts owed by contractors.

DLA COMMENTS: Concur.

INTERNAL MANAGEMENT CONTROL WEAKNESS: Partially concur. Although DNSC agrees a management control weakness does exist we do not agree that it qualifies as material. DODI 5010.40 states, "A Material Weakness must satisfy two conditions." The second condition is, "It must be a condition that requires the attention of the next higher level of management." We do not believe that this finding requires attention outside the Office of Stockpile Contracts.

RECOMMENDATION B.1: Recommend the Administrator, Defense National Stockpile Center, establish procedures for promptly clearing completed contracts and forwarding information to the Defense Financial and Accounting Service Columbus Center for the reversal of contract amounts and related storage and interest charges.

DLA COMMENTS: Concur. DNSC sent a team to DFAS Columbus Center in February 1998. As a result of that visit several recommendations for improved operations were made. DNSC management is in the process of evaluating these recommendations and will establish procedures to better accomplish Contract Administration to include promptly clearing completed contracts and forwarding information to the Defense Finance and Accounting Service Columbus Center.

DISPOSITION: Ongoing. ECD: August 1998

ACTION OFFICER: Cornel Holder, DNSC-P, (703) 767-5476

FINDING C: Accounting for Silver With the U.S. Mint. DNSC does not adequately manage its silver commodity. Specifically, DNSC does not receive any statements from the U.S. Mint (the Mint) on the amount of silver accountable to the Mint or on consignment. The Fund has a significant liability for silver it received without reimbursing the Mint. DNSC also has an asset account for a portion of silver that the Mint has taken back on consignment in order to make commemorative coins. The Mint does not provide confirmation because neither organization has addressed the issue of documentation needed to support these transactions. As a result, DNSC management does not know whether their records are accurate, or whether any discrepancies exist that require corrective action.

DLA COMMENTS: Concur

RECOMMENDATION C.1: Recommend the Administrator, Defense National Stockpile Center request that the U.S. Mint provide periodic written statements on the total amount of silver at Defense National Stockpile Center and the amount on consignment.

DLA COMMENTS: Concur. DNSC will request that the Mint, as part of its monthly report of sales, include a consignment balance. Any differences will be reconciled immediately. Also, DNSC will request that following the release of silver for consignment to the Mint, a written verification of both the amount released and the remaining inventory balance be done by both parties.

DISPOSITION: Ongoing. ECD: September 1998

RECOMMENDATION C.2: Recommend the Administrator, Defense National Stockpile Center request that the U.S. Mint provide a written explanation of the negative consignment balance of September 30, 1996.

DLA COMMENTS: Concur. DNSC will request that the Mint provide a written explanation to DNSC regarding the circumstances that resulted in a negative consignment balance as of Sept 30, 1996.

DISPOSITION: Ongoing. ECD: September 1998.

ACTION OFFICER: Thomas Gibbons, DNSC-P, (707) 767-5521

FINDING D: Value of Inventory. The DNSC Master Inventory File (MIF) and an inventory line item account on the FY 1997 Fund's Financial Statements, "Stockpile Materials," were overstated. This occurred because DNSC did not take timely action to decrease the carrying value of inventory that had declined in value or to write off identified inventory shortages. Specifically, DNSC did not decrease the carrying value of inventory that had declined in value because DNSC employees were not aware of the requirement. DNSC did not write off identified shortages because DNSC had no procedures to track and ensure that depleted commodities were written off. In addition, DNSC procedures did not require action on most shortages that are a small percent of total quantity, regardless of the dollar amount, and DNSC personnel believed that missing material may be located, which could reduce the shortages. As a result, "Stockpile Materials" and "Net Position," two line items on the FY 1997 Fund's Financial Statements, were overstated by at least $90.0 million. This represented 2.7 percent of the $3.32 billion in "Stockpile Materials." Furthermore, the lack of action on identified shortages delayed any investigation and decreased the likelihood of recovering any material.

DLA COMMENTS: Concur.

ACTION OFFICER: Frank Taylor, DNSC-DI, (703) 767-6530

RECOMMENDATION D.1: Recommend the Administrator, Defense National Stockpile Center identify commodities that have decreased in value below the recorded acquisition cost and reduce the "Stockpile Materials" line item account by the amount of the decrease.

DLA COMMENTS: Concur. SFFAS 3 requires stockpile materials be valued on the basis of historical cost. SFFAS 3 also provides an exception for the valuation of material with a permanent decline in value and requires that the decline be recognized as a loss or an expense in the period in which it occurs. DNSC has identified all commodities with a permanent decline in value and will reduce the "Stockpile Materials" line item account. In the future DNSC will adjust the "Stockpile Materials" line item account for any commodity determined to have a permanent decline in value.

DISPOSITION: Ongoing. ECD: September 1998

ACTION OFFICER: Stan Matthews, DNSC-L, (703) 767-6502

RECOMMENDATION D.2: Recommend the Administrator, Defense National Stockpile Center begin writing off all commodities known to be pending write-off, and require that such commodities be written off promptly in the future.

DLA COMMENTS: Concur. DNSC has an established procedure for inventory adjustments. As soon as all pertinent information and necessary data has been obtained a request for an inventory adjustment is prepared by the Depot Manager and forwarded to HQ for approval. After review and concurrence by DNSC Counsel the adjustment is approved by either the Director, Directorate of Strategic Materials Management or the Administrator. Obtaining all information for an adjustment request can take several months depending upon the commodity. DNSC-L will provide DNSC-M a listing quarterly of the commodities pending write off.

DISPOSITION: Considered Complete

RECOMMENDATION D.3: Recommend the Administrator, Defense National Stockpile Center revise procedures to require the investigation and write-off of identified shortages, including both physical shortages and discrepancies in the Master Inventory File, that are over a fixed dollar value or over a fixed percentage of quantity.

DLA COMMENTS: Nonconcur. DNSC has established procedures contained in the Stockpile Operations and Quality Assurance Manuals for identified inventory variances for material stored at DNSC facilities. Because of the nature of many of the DNSC commodities and the storage method actual counts are difficult and not cost effective. Therefore, DNSC uses a computed count method to establish inventory quantities. Official adjustments to depot inventory records are rarely approved based on a computed count. Identified major variations are reviewed and cost estimates prepared for an actual count verification. Since the computed values are estimates DNSC policy is to wait until all the inventory is shipped and then make appropriate adjustments in accordance with applicable procedures. Since values of commodities vary we utilize a fixed percentage as a barometer for reporting variances on stockpile inventories. Inconsistencies would occur in using acquisition values or current market data. Acquisition values either over/under state the current value of stockpile material, while current market value constantly fluctuate resulting in variations in identifying major/minor inventory deviations. Utilizing a fixed percentage provides a common denominator which is not effected by any variables which would alter the analysis.

DISPOSITION: Considered Complete

ACTION OFFICER: Vincent Cangro, DNSC-M, (703) 767-6518

RECOMMENDATION D.4: Recommend the Administrator, Defense National Stockpile Center direct that depot records be reconciled at least annually with the Master Inventory File.

DLA COMMENTS: Concur. The inventory reconciliation between the Master Inventory File (MIF) and Depot Inventory Record cards (46 cards) will be accomplished annually, beginning in FY 1999. The Standard Operating Procedure for this action has been completed and approved (attached).

DISPOSITION: Considered Complete

ACTION OFFICER: Stan Matthews, DNSC-L, (703) 767-6502

c. **Open Space**

(1) *Reference Location.* Pile No./Pad No.

(2) *Type.* Show one of the following:

(a) Type "A" Graded and Drained Natural Soil

(b) Type "B" Granular Stabilized Area

(c) Type "C" Asphalt Cement Concrete (Black Top)

(d) Type "D" Portland Cement Concrete (Concrete)

(e) Type "E" Soil Cement

(3) *Commodity.* Identify specific commodity.

(4) *Quantity.* Amount of commodity.

(5) *Unit of Measure.* Short tons (ST), long dry tons (LDT), etc.

(6) *Total Sq. Ft.* Gross square footage.

(7) *Occupied Sq. Ft.* Footprint area occupied by commodity.

(8) *Vacant Sq. Ft.* Total sq. ft. less occupied sq. ft.

(9) Entries are to be made in all columns for each item listed. Enter a zero "0" where appropriate.

3-7. Inventory Records

a. Inventory Record Card, DNSC 46, app. 3-C, will be used to record all receipts, shipments, and balances of Stockpile material by program, commodity, grade, type, and lot or countermarks when required.

b. Standard accounting practices should be followed in the correction of all errors so that prior entries are visible for inspection. No erasures or "white-out" of records shall be made on the card after the initial posting. All postings are to be made in permanent ink.

c. Semiannual (or more frequent) DNSC commodity inspections require the verification of inventory records with physical counts and/or computations of the material together with an explanation of discrepancies.

d. No adjustments to stock record balances, except those resulting from receipts, shipments, or error in posting are to be made without specific written authorization of DNSC.

(1) Some inventory balances will not be adjusted until the material is totally shipped.

(2) In case of a theft, quantities will be authorized to be adjusted when a final report from an investigative body confirms the loss and unlikelihood of recovery.

PART 11

CRITERIA AND PROCEDURES FOR INVENTORY ADJUSTMENTS

3-1101 GENERAL.

a. These procedures were developed by National Defense Stockpile Administrators in order to establish criteria and procedures for inventory adjustments.

3-1102 CRITERIA FOR INVENTORY ADJUSTMENTS.

a. Inventory by 100 percent actual count. When a physical inventory is taken and each piece or package of material can be seen and counted, a memo to the Director, Directorate of Strategic Materials Management should request that the official inventory record be adjusted based on this known count.

b. Inventory by count and computation.

(1) When a physical inventory is computed by counting the number of units in a stack, the number of stacks in a row, and the number of rows in a pile, and each piece or package is not seen and counted, the official inventory shall not be adjusted for minor variations.

(2) A minor variation is defined as the difference between the computed count and the inventory record (DNSC Form 46) not exceeding

(a) Two percent *(0.02)* for bagged materials, materials in irregular shapes, forms or packages, and crude rubber in irregular bales.

(b) One-half of 1 percent *(0.005)* for all other materials.
A difference in excess of these percentages is considered a major variation.

(3) For major variations, efforts shall be made to reconcile the variations by re-inventorying and examination of records for posting errors. If a major variation continues to exist, a cost estimate shall be made of rewarehousing the material for the purpose of confirming the count. Each such case shall be handled on an individual basis and a cost-benefit determination made. In those cases where the cost of rewarehousing is not justified by the benefits obtained, the new count-by-computation may be accepted and the inventory records adjusted accordingly.

3-1103 PROCEDURES FOR INVENTORY ADJUSTMENTS.

a. When, using the above criteria, an inventory adjustment is indicated following a physical inventory, the Chief, Quality Assurance and Technical Services

Division (DNSC-MQ) shall forward the following to the Director, Directorate of Strategic Materials Management (DNSC-M).

(1) Copy of the physical inventory report.

(2) Copy of the depot stock record (DNSC Form 46)

(3) Copy of any other pertinent documents.

b. The Chief, Quality Assurance and Technical Services Division (DNSC-MQ) shall also include in the transmittal letter his/her views as to actual or probable reasons for the inventory variations, recommendation concerning inventory adjustment, and cost estimate when required.

c. The Chief of Stockpile Operations and Logistics (DNSC-MO) shall reconcile the depot stock record with the official inventory and initiate appropriate correspondence to bring the two records into agreement.

d. After reconciliation of the two records, if the variation still exists, the Chief of Stockpile Operations and Logistics shall initiate appropriate correspondence to adjust inventory records.

e. Reporting and inventory adjustments for shortages known or suspected to be due to thefts shall be handled in accordance with theft reporting procedures.

STANDARD OPERATING PROCEDURES

FUNCTION: Reconciliation of DNSC Inventories	PAGE NO: 1 of 1

As a result of the Chief Financial Officer's Audit of DNSC for FY 1997, the following procedure has been put in-place. The purpose of this procedure is to strengthen internal controls over reconciling inventory records.

Effective April 1999, and annually thereafter, all DNSC inventories will be reconciled during the third quarter of the fiscal year. This process requires the joint effort of the Inventory Accountability Section and the Stockpile Operations Section. Tasking for this project will begin by the second week of April and is as follows:

Inventory Section: Generate working spreadsheet for the project. This spreadsheet shall be placed on the G:\ drive and named "RECONCILEXX.xls", where the XX represents the fiscal year reconciliation is completed. It shall list each commodity held at each depot with a total Master Inventory File (MIF) weight for each. There will also be columns for total 46Card (depot) weight, differences (the MIF weight minus the 46Card weight), percentage of total that's out of balance, and comments.

Operations Section and Depot Staff: Place 46Card totals on the spreadsheet

Inventory Section: Discrepancies will be resolved for commodities with either (1) weight differences greater than 2% of the total weight, or (2) weight differences valued at more than $5,000 in acquisition value.

Both Sections: Inventory Specialists, Operations Specialists, and Depot Staff, will combine efforts to locate discrepancies for their respective commodities. Each group has its own plan of attack for this phase, and is free to do whatever works. As discrepancies are resolved, the RECONCILEXX.xls spreadsheet is updated to reflect corrections.

Inventory Section: Once all differences requiring reconciliation have been resolved, the RECONCILEXX.xls spreadsheet will be submitted to the Chief of the Office of Financial Management within DNSC. A second copy shall be filed within the Inventory Section.

PREPARED BY:	DATE:	APPROVED BY:	DATE:
DNSC-L (INV)	12 May 98	Kenneth R. Davis	12 May 98

reconcdnscinv

FINDING F: Financial Statement Compliance With Regulations. The FY 1997 National Defense Stockpile Transaction Fund Financial Statements did not fully comply with DoD 7000.14-R, volume 6, chapter 6, "Form and Content of Audited Financial Statements," January 1998, and other criteria. Specifically, the statements did not disclose pension costs and environmental cleanup liabilities; misclassified silver inventory on consignment to the U.S. Mint; and did not properly add the FY 1997 operating results to "Cumulative Results of Operations." The noncompliance problems arose from the preparers' lack of knowledge of where to obtain information and lack of knowledge of the correct presentation of these amounts. As a result, the FY 1997 Fund's Financial Statements contained nonmaterial misstatements, therefore, the financial statements did not provide a complete disclosure of the Fund's financial position.

DLA COMMENTS: Partially Concur. DNSC does not agree that the environmental cleanup cost should be recorded as a contingent liability. SFFAS No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity." SFFAS No. 5 also establishes the criteria for recognition of a contingent liability as follows:

--A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).

--A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity...)

--The future outflow or sacrifice of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount).

Because DNSC has taken action to budget resources for environmental restoration on an ongoing operational basis we do not anticipate the filing of any legal claims. DNSC does not meet the criteria for recognition of a contingent liability because precautions have been taken for adequate storage and future cleanup.

The Treasury Financial Manual defines the General Ledger Account Codes. The definition for GLAC 2920 "Contingency Liabilities" is "the estimated value of a probable loss. Information must indicate it is probable that an asset has been impaired or a liability incurred; and the dollar amount of the loss can be reasonably estimated, or remote contingencies should be recorded in statistical (memorandum) accounts." The definition for GLAC 2995 "Accrued Clean-up Costs" is "The estimated liability for projected future clean-up costs associated with the removing, containing, and/or disposing of hazardous materials associated with the current portion of general and stewardship property, plant, and equipment operations.

Therefore, DNSC has concluded the recording of future environmental cleanup costs is more appropriately accomplished with the Accrued Clean-up Costs account.

ACTION OFFICER: Dixie England, DNSC-DF, (703) 767-5513/Frank Taylor, DNSC-DI, (703) 767-6530

RECOMMENDATION F.1: Recommend the Administrator, Defense National Stockpile Center determine the amount of pension expense required and record it in the accounting records, in accordance with Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995.

DLA COMMENTS: Concur. DNSC will take aggressive action to determine the amount of pension expense required and record it in the accounting records.

DISPOSITION: Ongoing. ECD: August 1998.

RECOMMENDATION F.2: Recommend the Administrator, Defense National Stockpile Center determine the total estimated amount for environmental cleanup and record it as a contingent liability in the accounting records.

DLA COMMENTS: Concur with intent. DNSC does not agree that this is a contingent liability. However, we do agree that we will have a future operating cost, therefore, we plan to use the Treasury General Ledger Account 2995 Accrued Clean-up Costs to report our estimated future outlays.

DISPOSITION: Considered Complete

RECOMMENDATION F.3: Recommend the Administrator, Defense National Stockpile Center reclassify the account for silver on consignment from "Advances and Prepayments" to a subaccount of "Stockpile Materials" or to "Other Assets," and report it in "Stockpile Materials" or "Other Federal (Intragovernmental) Assets" on future statements.

DLA COMMENTS: Concur. DNSC will instruct DFAS-CO to change GLAC 1415 "Advance to Government Agencies" to Glac 1900 "Other Assets" and report it on future statements.

DISPOSITION: Ongoing. ECD: July 1, 1998

ACTION OFFICER: Dixie England, DNSC-DF, (703) 767-5513
APPROVAL: David P. Keller, RADM, SC, USN, Commander, DLSC
COORDINATION: Mimi Schirmacher, DDAI, 767-6263

DLA APPROVAL:

E.R. CHAMBERLIN
Rear Admiral, SC, USN MAY 28 1998
Deputy Director

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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