Audit Report

REPORTING THE COST OF MILITARY PERSONNEL
ASSIGNED TO DEFENSE AGENCIES

Report No. D-2002-002 October 2, 2001

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DEPARTMENT OF DEFENSE
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October 2, 2001

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Audit Report on Reporting the Cost of Military Personnel Assigned to Defense Agencies (Report No. D-2002-002)

We are providing this report for your review and comment. We conducted the audit in support of our audit of the DoD Agency-wide financial statements for FY 2001 as required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense (Comptroller) did not provide comments to the draft of this report. Therefore, we request that the Under Secretary of Defense (Comptroller) provide comments by November 1, 2001.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Marvin L. Peek at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil) or Mr. Hoa H. Pham at (703) 604-9588 (DSN 664-9588) (hpham@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Acting Assistant Inspector General
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Office of the Inspector General, DoD

Report No. D-2002-002 **October 2, 2001**
(Project No. D2001FC-0110)

Reporting the Cost of Military Personnel Assigned to Defense Agencies

Executive Summary

Introduction. Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD and other Government agencies to prepare annual audited financial statements. Although not required by the Federal Financial Management Act, DoD believes that progress in achieving a favorable audit opinion to the DoD Agency-wide financial statements can be achieved if selected Defense agencies prepare annual stand-alone financial statements audited by certified public accounting firms. Therefore, in FY 2000, DoD required nine Defense agencies to prepare stand-alone financial statements. Of the nine Defense agencies, five had military personnel costs that were not recognized in the required financial statements.

Objectives. The primary audit objective was to determine whether Defense agencies required to prepare financial statements in support of the Chief Financial Officers Act accurately reported the cost of military personnel assigned. We also evaluated applicable guidance for reporting the cost of military personnel and reviewed potential costs to ensure that those costs are properly and consistently reported.

Results. Defense agencies receiving appropriated funds and required to prepare annual stand-alone financial statements did not include the cost of military personnel in their financial statements. Also, the FY 2000 financial statements for the Military Departments did not show that unreimbursed costs of military personnel assigned to Defense agencies were included in the reported cost for the Military Departments General Funds. As a result, the cost of military personnel assigned to five Defense agencies required to prepare stand-alone financial statements in FY 2000 was understated by approximately $144 million. The costs to be reported on the FY 2001 financial statements for the Military Departments could also be overstated by at least $811 million and understated by the same amount for the Other Defense Organizations-General Funds reporting entity. These amounts do not materially affect the total program costs and financial statements of the Military Departments. However, the financial statements for two of the five Defense agencies reviewed may be materially affected if the cost of military personnel assigned is excluded.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) revise DoD Regulation 7000.14-R, "Financial Management Regulation" to:

- address the computation and reporting of the cost of military personnel assigned to Defense agencies, and

- require the Military Departments to remove the cost of military personnel assigned to Defense agencies without reimbursement and included with Other Defense Organizations; or disclose such estimated costs in an appropriate footnote to the financial statements.

Management Comments. The Defense Advanced Research Projects Agency provided unsolicited comments and suggested that the recommendation be clarified to ensure that the cost of all military personnel be properly included or removed, as necessary, in the appropriate financial statements. The Under Secretary of Defense (Comptroller) did not comment on the report.

Audit Response. We clarified our recommendation to reflect the concerns of the Defense Advanced Research Projects Agency's comments. We also request that the Under Secretary of Defense (Comptroller) provide comments on the final report by November 1, 2001.

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Background

Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD and other Government agencies to prepare annual audited financial statements. The Inspector General, DoD, is responsible for auditing the DoD Agency-wide financial statements.

Other Defense Organizations. The DoD Agency-wide financial statements include two reporting entities for Other Defense Organizations: "Other Defense Organizations–General Funds" and "Other Defense Organizations–Working Capital Funds." Those entities represent consolidation of financial information from various Defense organizations and funds that use Treasury Index Symbol 97. The entities are considered "entities" for reporting purposes only in the annual financial statements required by the Chief Financial Officers Act. Other Defense Organizations include numerous Defense agencies that are authorized and assigned military personnel from the Military Departments. Defense agencies receiving appropriated funds do not reimburse the Military Departments for the military personnel assigned. However, Working Capital Funds are required to reimburse the Military Departments for use of military labor.

Defense Agencies Required to Prepare Stand-alone Annual Financial Statements. The Office of Management and Budget does not require Defense agencies to prepare audited stand-alone financial statements. However, DoD believes that progress can be achieved if selected Defense agencies prepare annual stand-alone financial statements that are audited by certified public accounting firms. Accordingly, DoD Regulation 7000.14-R, "Financial Management Regulation," volume 6B, "Form and Content of the Department of Defense Audited Financial Statements," October 2000, requires the following nine Defense agencies to prepare stand-alone annual statements.

- Defense Logistics Agency,
- Defense Finance and Accounting Service,
- Defense Information Systems Agency,
- Defense Contract Audit Agency,
- Ballistic Missile Defense Organization,
- Defense Advance Research Projects Agency,
- Defense Commissary Agency,
- Defense Security Service, and
- Defense Threat Reduction Agency.

Objectives

Objectives. The primary audit objective was to determine whether Defense agencies required to prepare financial statements in support of the Chief Financial Officers Act accurately reported the cost of military personnel assigned. We also evaluated applicable guidance for reporting the cost of military personnel and reviewed potential costs to ensure that those costs are properly and consistently reported. Appendix A discusses the audit scope and methodology.

Reporting the Cost of Military Personnel

Defense agencies receiving appropriated funds and required to prepare annual stand-alone financial statements did not include the cost of military personnel in their financial statements. Also, the FY 2000 financial statements for the Military Departments and the DoD Agency-wide financial statements did not show that military personnel assigned to Defense agencies were included in the reported cost for the Military Departments General Funds. Those conditions occurred because DoD Regulation 7000.14-R did not include guidance on:

- how Defense agencies should report the cost of military personnel provided to their organizations by the Military Departments, and
- how the Military Departments should report the cost of military personnel assigned to Defense agencies on a non-reimbursable basis.

As a result, the cost of military personnel assigned to five Defense agencies required to prepare stand-alone financial statements in FY 2000 was understated by approximately $144 million. The costs to be reported on the FY 2001 financial statements for the Military Departments could also be overstated by at least $811 million and understated by the same amount for the Other Defense Organizations–General Funds reporting entity. These amounts do not materially affect the total program costs and financial statements of the Military Departments. However, the financial statements for two of the five Defense agencies reviewed may be materially affected if the cost of military personnel assigned is excluded.

Regulatory Guidance on Recognizing and Reporting the Cost of Military Personnel

Federal Accounting Standards Advisory Board Guidance. Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," July 31, 1995, states that an entity should recognize in its accounting records the full cost of those goods or service provided to another entity, regardless of whether full reimbursement is received. The full cost of the goods or services provided should also be reported to the receiving entity by the providing entity. The Statement of Federal Financial Accounting Standard No. 4. also provides general criteria to help in determining the types of inter-entity costs that should or should not be recognized.

DoD Guidance on Recognizing the Cost of Military Personnel Assigned to Defense Agencies. DoD has different policies on how to include the cost of military personnel assigned to Defense agencies that have general fund activities and working capital fund activities. DoD Regulation 7000.14-R, volume 11A, chapter 1, September 1997, states that the applicable Military Personnel Appropriation shall fund the cost of direct and indirect military labor incurred in

the performance of a service or to the furnishing of materials to another DoD entity. Therefore, the cost of military labor shall not be charged to another DoD entity except for the cost of military personnel assigned to Defense Working Capital Fund organizations. DoD Regulation 7000.14-R, volume 11B, chapter 62, December 1994, requires Defense Working Capital Funds to reimburse for the cost of military personnel assigned, using civilian equivalency rates.

Civilian equivalency rates are established and provided by the Under Secretary of Defense (Comptroller) and are calculated by multiplying the current general schedule of civilian pay rates plus a fringe benefit factor. The civilian equivalency rates do not include the full cost of military personnel because military personnel are subject to military duties and responsibilities that may not directly benefit Defense agencies. The civilian equivalency rate policy recognizes that if the military requirements did not exist, some positions now staffed by military personnel could be staffed with civilians at a lower cost.

DoD Guidance on Reporting Costs in Financial Statements. DoD Regulation 7000.14-R, volume 6B, chapter 5, October 2000, requires reporting entities to include the full costs of the program outputs on the Statement of Net Cost. The costs of program outputs should include the costs of services provided by other entities whether or not the providing entity is fully reimbursed.

Reporting the Cost of Military Personnel Assigned to Defense Agencies

In a January 13, 2000, memorandum, the Under Secretary of Defense (Comptroller) directed nine Defense agencies to prepare financial statements and arrange for Certified Public Accounting firms to perform the financial statement audits. Five of the nine agencies had military personnel authorized and assigned and received annual appropriations from Congress.[*] However, those agencies did not report the costs of the military personnel assigned to their organizations. Table 1 shows the calculated annual costs, using the civilian equivalency rates, of the military personnel assigned to the five Defense agencies as of May 2001. Table 1 also shows total program costs reported on the FY 2000 financial statements.

[*]The remaining four agencies included the Defense Finance and Accounting Service and the Defense Commissary Service, which were working capital fund entities; the Defense Contract Audit Agency, which did not have military personnel assigned; and the Defense Security Service, which used temporary military reserve personnel whose costs were reimbursed.

Table 1. Cost of Military Personnel Assigned to Selected Defense Agencies Compared to FY 2000 Reported Program Costs
($ in thousands)

Defense Agency	Military Personnel Assigned[1]	Military Personnel Costs	Total Program Costs	Percent
Defense Information Systems Agency	1,639	$ 76,658	$ 1,628,354[2]	4.71
Defense Threat Reduction Agency	872	52,409	794,846	6.59
Defense Logistics Agency[3]	33	1,267	1,061,234[2]	0.12
Ballistic Missile Defense Organization	129	11,772	4,661,868	0.25
Defense Advanced Research Projects Agency[4]	16	1,565	1,943,901	0.08
Total Costs		**$143,671**		

[1]We assumed that the military personnel assigned as of May 2001 were the average personnel assigned for FY 2000.

[2]Those Defense agencies also have working capital fund entities. Those costs were not included.

[3]This agency did not prepare FY 2000 financial statements. In March 2000 the Defense Contract Management Command, a sub-command of the Defense Logistics Agency became a separate agency. The Defense Logistics Agency transferred 630 Military Personnel authorizations to the new Defense Contract Management Agency, which is not required to prepare stand-alone financial statements. The costs shown represent total reported program costs for the Defense Logistics Agency after deducting the costs identified with the Defense Contract Management Agency.

[4]This agency did not prepare financial statements for FY 2000. Total program costs were obtained from the Defense Finance and Accounting Service Indianapolis.

Accounting officials at the Defense agencies required to prepare stand-alone financial statements stated that they did not include the cost of military personnel in their total program costs. The costs were omitted because the Defense agencies did not incur such costs and were not required to reimburse the Military Departments for the military personnel expenses. In addition, DoD Regulation 7000.14-R did not provide any specific instructions for reporting those costs.

Reasons for not Reporting Cost of Military Personnel Assigned to Defense Agencies

DoD Policy. DoD has not established a requirement to report the cost of military personnel assigned to Defense agencies receiving appropriated funds because such information was not considered important or necessary in the past. Therefore, procedures for computing such costs have not been established. However, in our opinion, the use of the civilian equivalency rates for military personnel is an appropriate way for recognizing those costs. Other rates such as the Military Composite Rate and costs shown in the Future Years Defense Program could be used. However, the civilian equivalent rate seems to be more appropriate because military personnel are subject to military duties and responsibilities that may not be of direct benefit to the Defense agencies.

Office of Management and Budget and DoD Guidance. Office of Management and Budget Bulletin 97-01 (the Bulletin), as amended, and DoD Regulation 7000-14.R requires reporting entities to recognize specific inter-entity imputed costs that include: (i) employee pensions, (ii) health, life insurance, and other benefits for retired employees, (iii) other post-employment benefits including severance related costs, and (iv) losses in litigation proceedings. The Bulletin also states that to ensure consistency, agencies should not recognize costs (other than those listed above) until the Office of Management and Budget provides further guidance. However, the costs of military personnel identified in this report are intra-entity costs for DoD, and would not affect costs outside the DoD. The consolidated DoD Agency-wide financial statements are not affected by individual Defense agencies not including the cost of military personnel on their financial statements.

Effect on the Military Departments and Other Defense Organizations-General Funds Financial Statements

The Military Departments did not provide us with the total military personnel assigned to all Defense agencies. Therefore, we compared the cost of military personnel authorized, as shown in the Future Years Defense Program, with the reported FY 2000 program costs shown in the Statement(s) of Net Cost for the General Fund of each Military Department. Table 2 shows the comparison and provides a rough estimate of the effect of not reporting the unreimbursed costs of military personnel assigned to all Defense agencies. The analysis showed that the total program costs of the Military Departments General Funds would be overstated by an estimated 0.2 to 0.4 percent. The corresponding effect of excluding the costs of military personnel assigned to Defense agencies could understate total program costs shown on the Other Defense Organizations–General Funds entity by 1.5 percent.

Table 2. Military Personnel Authorized in Non-Working Capital Fund Positions at Defense Agencies Compared to Total FY 2000 Reported Program Costs
($ in millions)

Entity	Authorized Personnel	Costs of Personnel[1]	Total Program Costs	Percent
Army	4,756	$ 280	$ 87,754	0.3
Navy	3,341	203	94,522	0.2
Air Force	5,367	328	80,041	0.4
Total	**13,464**	**$ 811**	**$ 262,317**	0.3
Other Defense Orgs.-General Funds[2]	13,464	$ 811	$ 53,925	1.5

[1]The costs were taken from the FY 2001 Future Years Defense Program, October 2000, which is based on average pay from pay tables for each Military Department.

[2]The Other Defense Organizations-General Funds entity shown in the DoD Agency-wide financial statements include appropriated funds provided to the Special Operations Command and the Defense Health Program. However, military personnel and associated costs for those two entities are not included in the above figures. The FY 2001 authorizations for the Special Operations Command and the Defense Health Program, as shown in the Future Years Defense Program were 43,040 and 92,405, respectively. We excluded the military personnel and costs from our computation because the military personnel assigned to those programs are an intricate part of the military mission and are not really considered as separate Defense agencies. If the Special Operations Command and the Defense Health Program prepared stand-alone financial statements, the costs of military personnel assigned would represent a significant cost that should be shown on their financial statements.

Table 2 shows an estimated calculation of materiality to the Statements of Net Cost of the Military Departments and Other Defense Organizations–General Funds of incorrectly including or excluding military personnel assigned to Other Defense Organizations. To refine this estimate, the actual number of military personnel assigned to each Defense agency during the year would need to be multiplied by the appropriate civilian equivalency rate for each grade of military personnel assigned. However, the information shown in Table 2 gives an estimate of the effect on the financial statements of the Military Departments and Other Defense Organizations–General Funds. The costs do not appear to materially affect the total program costs for each Military Department.

Conclusion

Excluding the costs of military personnel assigned to Defense agencies should not materially affect the total costs in the DoD Agency–wide financial statements. However, excluding the cost of military personnel assigned to two of the five Defense agencies reviewed may materially affect their financial statements.

Incorrectly including the cost of military personnel assigned to Defense agencies has a small, non-material affect on the financial statements of each Military Department. Ideally, such costs should be excluded from the Statement(s) of Net Cost for each Military Department. However, DoD guidance should at least require an explanatory footnote in the financial statements of each Military Department and for Other Defense Organizations–General Funds. This note would show the estimated cost of military personnel included or excluded, as appropriate, from the program cost data shown in the Statement(s) of Net Cost and the Statement(s) of Financing. The Under Secretary of Defense (Comptroller) should provide specific guidance to ensure additional accuracy and consistency in reporting.

Recommendations, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense (Comptroller) revise DoD Regulation 7000.14-R, "Financial Management Regulation" to address the computation and reporting of the cost of military personnel assigned to Defense agencies. As a minimum this guidance should:

1. Provide a standard methodology for computing the unreimbursed cost of military personnel assigned to Defense agencies that are required to prepare stand-alone financial statements.

2. Require Defense agencies that prepare stand-alone financial statements to report the cost of military personnel assigned to their agencies.

3. Require the unreimbursed cost of military personnel assigned to Defense agencies to be removed from the Military Departments' financial statements and included in the financial statements for Other Defense Organizations–General Funds; or disclose the estimated costs of those military personnel in an appropriate footnote to the financial statements.

Management Comments. The Defense Advanced Research Projects Agency provided unsolicited comments and suggested that Recommendation 3 be modified to recognize all the costs of Military personnel assigned to Defense agencies in the Other Defense Organizations–General Funds column of the DoD Agency–wide financial statements.

Audit Response. We incorporated additional wording in Recommendation 3 to clearly show that costs removed from the Military Department's financial statements should be included in the financial statement of Other Defense Organizations–General Funds.

Management Comments Required

The Under Secretary of Defense (Comptroller) did not comment on the report. Therefore, we request that the Under Secretary of Defense (Comptroller) provide comments on the final report.

Appendix A. Audit Process

Scope and Methodology

Worked Performed. We reviewed the Future Years Defense Program to determine the number of military personnel assigned to each Defense agency. We evaluated the process used by the Defense agencies required to prepare stand-alone financial statements to account for the costs of military personnel assigned to their organizations. Specifically:

- We obtained and reviewed financial statements or other appropriate financial data for the Defense agencies required to prepare stand-alone financial statements for FY 2000. Also, we computed the cost of military personnel assigned for the five Defense agencies that received annual appropriations. We computed the cost by multiplying the assigned strength as of May 2001 to the annual civilian equivalency rates provided by the Under Secretary of Defense (Comptroller).

- We evaluated the method that the Defense Working Capital Fund organizations used to reimburse Military Departments for the costs of military personnel assigned to their organizations.

- We reviewed applicable laws, policies, procedures, and regulations related to the computation and allocation of military personnel expense. We also held discussions with Defense agencies accounting officials responsible for the preparation and presentation of the total Defense agencies program costs.

DoD-Wide Corporate-Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act the Secretary of Defense annually establishes DoD–wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following corporate goal, subordinate performance goal, and performance measure.

FY 2001 DoD Corporate-Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-02)**

FY 2001 Subordinate Performance Goal 2.5: Improve DoD financial and information management. (01-DoD-2.5)

FY 2001 Performance Measure 2.5.2: Achieve unqualified opinions on financial statements. **(01–DoD-2.5.2.)**.

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

Use of Computer-Processed Data. We did not use computer-processed data to support the audit conclusions.

Audit Type, Period, and Standards. We performed this financial-related audit from May 2001 through July 2001, in accordance with generally accepted Government auditing standards based on the limited objectives, scope, and methodology discussed in this appendix. In addition, the Inspector General, DoD, has been unable to obtain an opinion on our system of quality control. The most recent external quality control review was withdrawn on March 15, 2001, and we will undergo a new review.

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

Management Controls. We did not review the management control program for the Defense agencies included in this audit. The management control programs for those agencies will be evaluated by the independent public accounting firms as part of their audit of Defense agencies' financial statements.

Prior Coverage

No prior coverage has been conducted on the specific subject of this audit. However, the General Accounting Office, the Inspector General, DoD, and the Military Department audit agencies have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at http://www.gao.gov. Inspector General, DoD, reports can be accessed on the Internet at http://www.dodig.osd.mil/audit/reports.

Appendix B. Report Distribution

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  Deputy Comptroller (Program/Budget)

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Auditor General, Department of the Army

Department of the Navy

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

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Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
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House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform

Defense Advanced Research Projects Agency Comments

DEFENSE ADVANCED RESEARCH PROJECTS AGENCY
3701 NORTH FAIRFAX DRIVE
ARLINGTON, VA 22203-1714

MEMORANDUM FOR UNDERSECRETARY OF DEFENSE (COMPTROLLER) SEP 4 2001

SUBJECT: Audit Report on Reporting the Cost of Military Personnel Assigned to Defense Agencies (Project No. D2001FC-0110)

As requested by your staff, the Defense Advanced Research Projects Agency (DARPA) is providing comments on the subject audit report for incorporation into a consolidated response.

Footnote 4 of Table 1 on page 5, states that DARPA did not publish FY 2000 financial statements. The Defense Finance and Accounting Service prepared financial statements for DARPA but the statements did not include costs for DARPA's military personnel. When DARPA met with the auditors, we advised them that DARPA would have reported the military costs and associated imputed costs if DARPA had published its FY 2000 financial statements. We also advised the auditors that we would have used the published DoD Composite Rates for reporting costs. DARPA requests that the footnote be revised to reflect our position.

Based on our review of the audit recommendations, we believe the recommendations as stated would result in an understatement of military personnel costs in the DoD consolidated financial statements. Recommendation 3 requires the Military Departments to remove from the body of their financial statements their costs associated with military personnel assigned without reimbursement to Defense agencies and report those costs in a footnote. However, there is no recommendation for recognizing all of the military personnel costs in the Other Defense Organizations (ODO) -- General Funds column of the DoD consolidated financial statements. The only ODO military personnel costs that would be recognized would be those for Defense agencies required to publish stand-alone financial statements. To make Recommendation 3 work, all Defense agencies should be required to report the Military Service and grade of all military personnel assigned on a nonreimburseable basis so DFAS can determine military personnel costs and recognize them in the reported ODO costs. If this action is not taken, Recommendation 3 should be revised to only remove the military personnel costs that are reported by Defense agencies required to prepare stand-alone financial statements. This would result in a nonmaterial overstatement of the Military Departments' costs and an understatement of the ODO costs; however, it would have no effect on the DoD consolidated statements.

My point of contact for this matter is Mr. Mike Bryant. He may be reached by e-mail (mbryant@darpa.mil) or by telephone at (703) 696-2415.

William E. Lehr, III
Comptroller

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

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