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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Secretary Of The Air Force

**Department Of The Air Force's
First-Year Implementation
Of The Federal Managers'
Financial Integrity Act**

GAO conducted a review of 22 federal agencies' efforts to implement the Federal Managers' Financial Integrity Act of 1982. The act was intended to help reduce fraud, waste, and abuse across the spectrum of federal government operations through annual agency self-assessments of their internal controls and accounting systems.

This report highlights the progress made and problems encountered by the Department of the Air Force in its first year of experience with this new act. The report focuses on the Air Force's efforts to evaluate internal controls, review accounting systems, and improve the evaluation processes as a result of identified problems.



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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

B-202205

The Honorable Verne Orr
The Secretary of the Air Force

Dear Mr. Secretary:

This report presents the results of our review of the Air Force's first-year efforts to implement and comply with the Federal Managers' Financial Integrity Act of 1982. Our review was part of a governmentwide assessment of the act's first-year implementation.

The Air Force has made progress in the first year. Its effort is impressive considering the scope of the Air Force's program and the fluid environment of the first year. This year was characterized by evolving Office of Management and Budget (OMB) guidance, tight Department of Defense (DOD) deadlines, a continuing need to provide better guidance and training to managers involved in the process, and the Air Force's belief that vulnerability assessments were only a minor step on the way to performing internal control reviews. We recognize the difficulties and are therefore offering our comments, not as criticism of the first year, but as suggestions for the second and subsequent years. As improvements are made, the required annual report on internal controls should become more meaningful.

The following presents the highlights of our evaluation. Details of our observations, as well as an explanation of our objective, scope, and methodology for this review, are in appendix I.

DOD REPORTING UNDER THE FEDERAL
MANAGERS' FINANCIAL INTEGRITY ACT

The Department of the Air Force, as one of 24 DOD reporting centers, is required by DOD Directive 7040.6 to implement an internal control program and report annually to the Secretary of Defense on the adequacy of its systems of internal accounting and administrative controls. The Air Force must also report on

whether its accounting systems conform to the principles, standards, and related requirements prescribed by the Comptroller General of the United States. The report helps provide the basis for the Secretary of Defense's annual report to the President and the Congress on the adequacy of DOD's internal controls, as required by the Financial Integrity Act.

THE AIR FORCE'S INTERNAL
CONTROL EVALUATION PROGRAM

The Air Force generally implemented its internal control program in accordance with the intent of OMB's guidelines. The guidelines provide a basic approach to evaluating, improving, and reporting on internal controls. OMB recommends the following process as an efficient, effective way to perform the required evaluations: (1) organize the internal control evaluation process, (2) segment the agency into smaller entities by function, program, or activity, (3) assess the vulnerability of the smaller segments to determine the risk of waste, loss, unauthorized use or misappropriation, (4) review internal controls, (5) take corrective actions, and (6) annually report on the adequacy of internal controls.

The Air Force effectively
organized the program

The Air Force organized its internal control evaluation process in a way that promotes institutionalization of the program. Rather than create a separate office, the Air Force used existing resources and involved managers at all levels. The program had the support of top Air Force officials, with oversight responsibility placed with the Assistant Secretary for Financial Management. Program responsibility was given to the Comptroller of the Air Force. In addition, the Air Force effectively used the Air Force Audit Agency in designing and implementing the program. The Audit Agency also performed a quality assurance function for the Air Force Comptroller.

The Air Force
combined key phases

OMB's guidelines require each agency to establish a complete inventory of its functions, programs, or activities (the segmentation phase), and then to assess the vulnerability of each area (the vulnerability assessment phase). The Air Force, however, initially believed that internal control reviews were more important than vulnerability assessments. As a result, it combined the segmenting and vulnerability assessment phases without establishing a complete inventory of all Air Force functions, programs, and activities.

The resulting "Master Vulnerability Assessment List" contains only those areas considered highly or moderately vulnerable. Important functions, such as telecommunications and intelligence, were omitted and not evaluated. Without a complete inventory of functions and activities, the Air Force has little assurance that it has identified all potentially vulnerable areas, focused its internal control reviews into the highest risk areas, and surfaced its material internal control weaknesses.

The Air Force subsequently acknowledged the problems inherent in combining the segmentation and vulnerability assessment phases. It plans to develop a complete inventory of its activities, functions, and programs and to assess the vulnerability of each area during fiscal year 1984.

Numerous internal control reviews but ADP coverage limited

The Air Force reported conducting over 4,400 internal control reviews, covering 26 subject areas in fiscal year 1983. This was a commendable effort and is ample demonstration of the Air Force's commitment. As in any first-time effort, however, problems arose during the course of the year.

The new Air Force guidelines issued for the second-year effort should solve most of the problems. One area, however, has not been adequately addressed. First-year Air Force guidance was silent as to how ADP controls should be considered in reviews of automated systems. The second-year guidance, while calling for increased ADP consideration, did not require a complete evaluation of application controls. Application controls range across the input, processing, and output phases, and include such controls as supervisory review of input, verification of master file updates, and review of output for accuracy. The new guidelines require evaluations of the input and output controls, but such evaluations are incomplete without evaluations of the processing controls.

Identification of material weaknesses should be more specific

In the November 14, 1983, report to the Secretary of Defense, the Air Force identified four areas as having material weaknesses: foreign military sales financial management, spare parts acquisition (pricing), weapon system acquisition (cost growth), and payroll operations. The act provides for disclosure of the identified material weaknesses along with the plans

and schedule for corrective actions. The Air Force report, while generally outlining areas of concern, does not specifically address the problems or the material weaknesses. For example, foreign military sales financial management is listed as a "material weakness," but the Air Force report does not identify what the specific problems are, implying that the entire subject area is materially weak. Unless specific problems and, if known, the associated internal control weaknesses are identified, neither the Air Force, the Office of the Secretary of Defense, nor the Congress can effectively address or measure the successful resolution of the problems.

Accounting systems evaluations
should be more comprehensive

In addition to an annual report on internal control systems, agencies are required to report annually on whether their accounting system's conform to the Comptroller General's accounting principles, standards, and related requirements. The Air Force's first-year efforts to evaluate their accounting systems were reasonable. However, future evaluations should be more comprehensive to support the compliance statement. Specifically, the Air Force needs to (1) develop a comprehensive systems inventory which includes operating accounting system segments, (2) prepare written policies and procedures for evaluation of accounting systems, and (3) evaluate the accounting systems and segments in operation.

The Comptroller's office plans to develop a comprehensive systems inventory, prepare written policies and procedures, and conduct more detailed system evaluations during fiscal year 1984.

Army and Air Force Exchange Service
should report under the act

The Army and Air Force Exchange Service, based on an opinion from its General Counsel, decided that the Exchange Service is not subject to the act's requirement to report on its internal controls. We believe that the Exchange Service should be covered as a matter of policy. The Exchange Service's high volume of sales (\$4.3 billion in fiscal year 1982), and the history of poor internal controls make the Exchange Service very vulnerable to loss, waste, and unauthorized use of assets.

Our draft report to the Secretary of Defense on The Department of Defense's First-Year Implementation of the Federal Managers' Financial Integrity Act, GAO/NSIAD-84-93, dated May 1, 1984, contained a proposal to require, as a matter of policy, the Exchange Service to follow the provisions of the act and

that either the Army or the Air Force be given permanent responsibility for the Exchange Service's internal control evaluation program. Subsequent to reviewing the draft, the Assistant Secretary of Defense for Manpower, Installations and Logistics, directed that the Exchange Service be included in the DOD program, and requested the Secretaries of the Army and the Air Force to assign permanent responsibility by September 30, 1984. Because of this action, we have deleted the proposal from the final report. We will, however, continue to monitor the Exchange Service's progress in implementing the internal control evaluation program.

AGENCY COMMENTS

Air Force officials reviewed a draft of this report that contained proposed recommendations to (1) amend the Air Force's internal review guidance and require coverage of ADP processing controls and (2) improve the specificity of future internal control reports to the Secretary of Defense. Air Force officials concurred with the report and its recommendations and issued written instructions to effect the necessary changes. (See app. IV.) Because of their concurrence, we have removed the proposed recommendations. We will, however, continue to monitor the Air Force's progress in these and other areas.

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We are sending copies of this report to the House Committee on Government Operations; the Senate Committee on Governmental Affairs; the House and Senate Committees on Appropriations, Armed Services, and the Budget; the Director, OMB; and the Secretary of Defense.

Sincerely yours,


Frank C. Conahan
Director

C o n t e n t s

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ABBREVIATIONS

ADP	Automated Data Processing
DOD	Department of Defense
GAO	General Accounting Office
OMB	Office of Management and Budget

THE AIR FORCE'S FIRST-YEAR IMPLEMENTATION
OF THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT

Responding to continuing disclosures of loss, waste, unauthorized use, or misappropriation of assets, which were largely attributable to serious weaknesses in agencies' internal controls, the Congress, in 1982, enacted the Federal Managers' Financial Integrity Act, 31 U.S.C. 3512(b) and (c). The act was designed to strengthen the existing requirement of the Accounting and Auditing Act of 1950 that executive agencies establish and maintain systems of accounting and internal control to provide effective control over and accountability for all funds, property, and other assets for which the agency is responsible [31 U.S.C. 3512(a)(3)].

We believe that full implementation of the Financial Integrity Act will enable the heads of federal departments and agencies to identify their major internal control and accounting problems and improve controls essential to the development of an effective management control system and a sound financial management structure for their agency. To achieve these ends the act requires:

- Each agency to establish and maintain its internal accounting and administrative controls in accordance with the standards prescribed by the Comptroller General, so as to reasonably assure that: (1) obligations and costs comply with applicable law, (2) all funds, property and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures are recorded and properly accounted for.
- Each agency to evaluate and report annually on internal control systems. The report is to state whether agency systems of internal control comply with the objectives of internal controls set forth in the act and with the standards prescribed by the Comptroller General. Agency reports must identify the material weaknesses involved and describe the plans for corrective action.
- Each agency to prepare a separate report on whether the agency's accounting systems conform to principles, standards, and related requirements prescribed by the Comptroller General.

- The Office of Management and Budget (OMB) to issue guidelines for federal departments and agencies to use in evaluating their internal accounting and administrative control systems. These guidelines were issued in December 1982.
- The Comptroller General to prescribe standards for federal agencies' internal accounting and administrative control systems. The Comptroller General issued these standards in June 1983.

This report on the Air Force is one of 22 reports on federal agencies' efforts to implement the act during the first year.

THE AIR FORCE'S INTERNAL CONTROL EVALUATION PROCESS

The Air Force's internal control evaluation process generally followed the intent of the OMB recommended approach. The OMB guidelines recommend the following process as an efficient, effective way to perform internal control evaluations: (1) organize an internal control evaluation process; (2) develop an agencywide inventory of programs, functions, or activities (segmentation); (3) assess the vulnerability of items in the inventory to determine the risk of waste, loss, unauthorized use, or misappropriation; (4) review the internal controls in programs, functions, or activities according to their potential vulnerability; (5) take corrective actions; and (6) report on the adequacy of internal controls and plans for corrective action.

The first year of the Air Force's internal control evaluation program was hampered by tight DOD deadlines, evolving OMB guidance, a continuing need to provide better guidance and training to managers involved in the process, and a belief that vulnerability assessments were only a minor step on the way to performing internal control reviews. The Air Force has made a substantial good faith effort, and its second-year program will be improved by the lessons learned in the first year. As improvements are made in the second and subsequent years, the Air Force's annual reports on internal controls should become more meaningful.

Organization

The Air Force has made progress organizing and establishing its internal control evaluation program. It assigned program responsibilities to the Comptroller of the Air Force, established internal reporting channels, and identified critical

personnel, all within existing resources. As suggested by OMB and DOD, the Air Force Audit Agency independently reviewed the effectiveness of the program implementation.

Segmentation

Senior officials segmented the Air Force along functional lines (e.g., logistics and engineering, personnel, procurement, etc.) and included almost all its programs. The Air Force did not divide these segments into smaller entities prior to performing vulnerability assessments.

Vulnerability assessments

After establishing its major segments, the Air Force went directly into the vulnerability assessment phase. Officials at Air Force headquarters identified and prepared a list of potentially vulnerable areas within the segments (major functions). They sent this listing to the field commands for comment. This phase resulted in a final list of 148 potentially vulnerable areas. The Air Force did not rank these areas into high, medium, and low as suggested by OMB's guidelines.

Internal control reviews

Headquarters officials selected 48 areas for Air Force-wide internal control reviews during fiscal years 1983 (26 areas) and 1984 (22 areas). The reviews are being performed at the base level and generally follow OMB's guidelines. The results of the fiscal year 1983 reviews were reported to Air Force headquarters through the major commands. During 1983, over 4,400 reviews were performed Air Force-wide.

Reporting and corrective actions

The results of the internal control reviews, along with information gathered from internal and external audit reports, culminated in the Air Force report on internal controls. The report highlighted four areas of concern--foreign military sales, spare parts acquisition, weapon systems acquisition, and payroll operations.

The Air Force recognizes that to achieve maximum benefit from its 1983 program, internal control weaknesses must be corrected and compliance problems must be evaluated Air Force-wide. To achieve this objective, the Air Force is establishing a follow-up program to ensure corrective actions are completed and is distributing details of known compliance problems to all field commands.

AIR FORCE'S EFFORTS TO DETERMINE
ACCOUNTING SYSTEM COMPLIANCE

The Air Force Comptroller's organization performed the accounting system compliance effort this first-year. The accounting systems inventory contained 29 operating systems, 23 of which the Air Force deemed in full compliance with the Comptroller General's accounting principles and standards. The compliance determinations primarily consisted of the system managers' judgments that the systems were in compliance based on general operating knowledge and audit reports. To correct known system deficiencies, the Air Force has developed individual corrective action plans for each of the six systems not in compliance. (See app. II.) It has established a follow-up process to monitor the corrective actions.

The Air Force Audit Agency's memorandum to the Secretary of the Air Force on the first-year effort stated that the Secretary's report was complete and accurate, based on past reviews of the accounting systems.

THE ROLE OF THE AUDITOR GENERAL

The Air Force Audit Agency played an active role in the Air Force's first-year effort to implement the act. The Audit Agency provided technical assistance to all levels of Air Force management and conducted an audit to evaluate the Air Force's internal control evaluation process. In addition, the Auditor General provided statements to the Secretary of the Air Force commenting on (1) whether the Air Force's process complied with the intent of the OMB guidelines and (2) the completeness and accuracy of the Air Force's statement on accounting systems conformity. The Audit Agency also provided quality assurance by providing continuous feedback on their audit findings during the implementation process.

IMPROVEMENTS NEEDED FOR FUTURE
INTERNAL CONTROL EVALUATIONS

The Air Force has made progress in complying with OMB's guidelines for evaluating internal controls. The first-year effort included over 4,400 internal control reviews, conducted Air Force-wide, and covered 26 subject areas. As in any first-time effort, however, problems arose during the year. These problems involved

- inconsistent and nondirective guidance from many different sources, compounded by a lack of training, that led to performance and documentation problems;

- a combined segmentation and vulnerability assessment phase that excluded some agency activities and programs;
- an internal control review phase that provided insufficient coverage of automated data processing (ADP) controls; and
- a first-year report to the Secretary of Defense that highlighted areas of concern but did not disclose the specific weaknesses or problems in the areas of concern.

Better guidance and training needed
to improve evaluation process

The Air Force encountered many problems in performing and documenting its first-year internal control evaluation process. The Air Force Audit Agency reported that whenever weaknesses in performing and documenting vulnerability assessments and internal control reviews were found, confusion caused by general, inconsistent, and nondirective guidance from many different sources was also present. Vulnerability assessments and internal control reviews generally lacked documentation of the methodology used and rationale for conclusions reached. In addition, internal control reviews were generally found to be inadequately performed and many had to be redone.

For example, the Air Force Audit Agency evaluated 51 internal control reviews and reported that

- 24 (47 percent) of these reviews had performance problems and
- 31 (61 percent) of these reviews had documentation problems.¹

The Audit Agency recommended that 14 (27 percent) of these reviews be redone.

Recognizing the problems, the Air Force strengthened its evaluation process by issuing improved internal control review guidelines. The new guidance should help eliminate many of the

¹Some reviews had multiple problems.

first-year problems. According to Air Force officials, the Air Force plans to develop similar guidance for the vulnerability assessment process.

The Air Force's first-year documentation and performance problems also resulted from a lack of training for the managers involved in performing vulnerability assessments and internal control reviews. The Air Force had no standardized training program for its managers. Available training was generally limited to an occasional briefing or short workshop. Standardized training is needed to strengthen the entire internal control evaluation process (vulnerability assessments and internal control reviews) so that everyone involved has the same understanding and interpretation of the process. The Air Force, however, continues to rely on the individual major commands to interpret the new guidance, formulate training, and give the training.

Air Force segmentation and vulnerability assessments can be improved

Because the segmentation and vulnerability assessment phases are the bases for selecting subjects for detailed internal control reviews, we believe they are critical to effectively and efficiently evaluating internal control systems. These phases should produce a prioritized listing of all potentially vulnerable areas, permitting an agency to efficiently focus its resources during the internal control review phase. Without successful completion of both phases, all high-risk areas might not be identified and internal control reviews might not be properly focused, potentially wasting agency resources, and allowing internal control weaknesses to go undetected and uncorrected.

OMB's guidelines suggest a two-step segmentation phase before performing vulnerability assessments: first, divide the agency into organizational or other components (segments) and then, within each segment, identify the programs and administrative functions (assessable units). The basic objective of the segmentation phase is to develop an agencywide inventory of assessable units so that all agency programs and administrative functions can be the subject of a vulnerability assessment. Senior Air Force officials segmented the Air Force along major functional lines (e.g., logistics and engineering, financial management, procurement, manpower and personnel, etc.). At this point, however, the Air Force proceeded directly to vulnerability assessments, without first developing an inventory of assessable units.

Since the segments (major functions) corresponded to Air Force headquarters staff responsibilities, the headquarters staff examined their respective functional areas to identify

potentially vulnerable areas. These officials identified areas they considered potentially vulnerable, but did not document how they reached their conclusions.

Some of these officials did not assess all of their areas of responsibility. For example, we were told that

--a complete review to produce a prioritized ranking of programs and functions vulnerable to fraud, waste, and abuse is impractical;

--Air Force guidance was not specific enough to justify the resources and time necessary to perform systematic assessments; and

--reporting potentially vulnerable areas could jeopardize future budgets.

As a consequence, the lists prepared by the headquarters staff did not include all of their potentially vulnerable areas. For example, telecommunications and intelligence were omitted.

Our review also disclosed that the scope of some of the identified areas may be too broad to permit meaningful, timely internal control reviews. The areas identified included, for example, supply system management and the depot maintenance industrial fund. The Air Force Audit Agency noted that supply systems management was a large area covering many systems, making specific internal control reviews very difficult. Further, Air Force Logistics Command officials believe, and we agree, that the depot maintenance industrial fund is much too broad for an internal control review. Logistics Command personnel plan a six-month evaluation to further segment this area before performing internal control reviews.

Key Air Force officials acknowledged the problems in the segmentation and vulnerability assessment phases and are planning to repeat the segmentation phase and conduct new vulnerability assessments in fiscal year 1984.

Internal control reviews
should be better focused

In addition to the performance and documentation weaknesses in internal control reviews, other problems arose during the first year. Examples of these problems are

--little attention being paid to application controls of ADP systems,

- duplication of effort between existing oversight activities (audits, self inspection, etc.) and internal control reviews,
- inefficient use of resources in conducting every review at every location, and
- each base level reviewer examining the adequacy of Air Force regulations and other standard internal control mechanisms.

The Air Force's new second-year guidance should solve most of these weaknesses. However, a need for better coverage of ADP controls in internal control reviews exists. Information systems management (data automation) is found in virtually every Air Force activity and affects practically every Air Force internal control system. Thus, a thorough internal control review should include a review of ADP system controls.

The Air Force provided no guidance on how ADP controls should be considered in internal control reviews of functional areas dependent on ADP support. Consequently, these controls were inconsistently addressed during internal control reviews. In supply, for example, the Military Airlift Command and Strategic Air Command both depend on automated systems, but neither addressed the automated portion of supply systems during their review of the Air Force's vulnerability assessment list. During the supply systems' internal control review, Strategic Air Command included a section on ADP--primarily, environmental and physical security issues and control over data input--while Military Airlift Command did not address ADP at all.

The internal control review of the medical/dental stock fund also demonstrates the need for better guidance on ADP controls. At Military Airlift Command, the internal control review of the stock fund covered a wide range of application controls, including control of input submitted for processing, controls over error correction, and monitoring of data base integrity. At Strategic Air Command, an agency official told us that the internal control review covered only minimal ADP-type controls dealing with the comparison of computer printouts to physical inventories. Other Air Force commands did not consider application controls at all.

The Air Force's new second-year guidance, while calling for increased ADP consideration, does not require an evaluation of all internal controls within the ADP system. The new guidance emphasizes ADP input and output controls, but is silent on ADP processing controls (internal to the ADP system). Thus, an

internal control review in an area dependent on ADP systems that only covers ADP input and output controls may allow control weaknesses to remain undetected.

The Acting Assistant Secretary for Financial Management, in response to a proposed recommendation made in a draft of this report, has directed the Air Force to amend the second-year guidance and include coverage of ADP processing controls during internal control evaluations.

Specificity needed to fully appreciate weaknesses identified in annual report

As previously indicated, the Air Force's internal control evaluation process culminated in a November 14, 1983, report from the Secretary of the Air Force and the Chief of Staff to the Secretary of Defense. Although essentially following the OMB format, we did note an area of the report that could be improved. (Appendix II contains extracts from the Air Force's report on material weaknesses.)

The act provides for the disclosure of an agency's material internal control weaknesses. The Air Force's report, however, did not provide descriptions of material weaknesses requiring corrective action. The report instead identified major areas categorized as departmentwide problem areas without disclosing the problems or weaknesses within the areas. For example, foreign military sales financial management was identified as having weaknesses. Rather than identifying known problems, the report simply states "Our concerns in this area are well documented by various oversight units." Another example is the spare parts acquisition area. The report indicated that the Air Force has been investigating the causes for sharp increases in spare parts prices and that they fully appreciate the need for improvements in this area. Here again, there was no specific identification of the known problems.

We believe that specificity within the annual report is essential and can be improved without significantly increasing the size of the report. The weaknesses could be summarized in a relatively short space that concentrates on the problem. In the foreign military sales financial management area, for example, known problems such as full costs not being billed to the customer's account and not reporting deliveries when they are made, could have been listed without appreciably extending the length of the report.

Listing specific material weaknesses will allow the reader to fully appreciate the identified problems without needing backup documentation. In addition, specificity will allow the Air Force, DOD, and the Congress to measure the Air Force's progress in correcting the weaknesses.

In response to a proposed recommendation made in a draft of this report, the Acting Assistant Secretary for Financial Management has directed that all future reports to the Secretary of Defense will include specific weaknesses and/or problems.

IMPROVEMENTS NEEDED FOR FUTURE
ACCOUNTING SYSTEM COMPLIANCE EVALUATIONS

The Air Force's first-year effort to comply with section 4 of the act was reasonable; however, much more needs to be done to ensure that future compliance efforts are comprehensive and appropriately support the annual reports. The Air Force needs to develop a comprehensive inventory of its major accounting systems and system segments to ensure that all compliance evaluations required by the act are made, and to perform evaluations of the systems in operation to ensure full compliance with the Comptroller General's accounting principles and standards.

Accounting systems inventory
should be complete

To ensure that all accounting systems are identified and evaluated for compliance with the Comptroller General's accounting principles and standards, DOD instructions require that a complete accounting systems inventory be developed and verified. The inventory should include all systems and system segments which authorize, record, classify, and report on operations related to revenues, expenses, assets, liabilities, and equity.

The Air Force reported 29 accounting systems to DOD as its inventory. The inventory, however, only included the primary systems and does not contain, in certain cases, the major support segments of those systems. For example, the system documentation of the Civilian Pay System (a primary system) does not contain references or data on the foreign national pay systems that support it. As a result, these support systems were not considered in this year's evaluation effort.

We believe that the Air Force should maintain a comprehensive inventory of all operating systems and segments so that none would be overlooked for compliance evaluations. Further, to help ensure uniformity in establishing accounting systems inventories by all the military services, the Air Force should comply with DOD instructions for establishing accounting system inventories.

The Air Force now plans to require that all system segments be properly identified in the primary system design documentation. This will require system managers to review and update documentation where necessary and thus give the Air Force better control over its accounting systems.

Compliance evaluations were limited

During this first year, the Air Force determined that 23 systems were in full compliance with the Comptroller General's accounting principles and standards. In making these determinations, Air Force officials considered one or more of the following: (1) whether the accounting system design had been approved by GAO, (2) internal audit and GAO audit findings, (3) the judgment of system managers, and (4) the accounting principles and standards. While the approach used in the initial year for making determinations adequately conformed to DOD instructions, we believe that the Air Force should test the systems in operation. Such testing would make the annual conformance statements more meaningful in future years.

Air Force officials informed us that more will be done in the future regarding evaluation of systems with the Comptroller General's principles and standards.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our review was to assess the Department of the Air Force's process for implementing the Federal Managers' Financial Integrity Act. Our review included:

- Interviewing responsible officials and reviewing pertinent program documentation at Headquarters, Air Force and selected field activities (see app. III). The activities were selected to obtain a cross-section of both operational and support activities.
- Using the act itself, OMB's Circular A-123 and Internal Control Guidelines, and DOD's guidance as criteria in judging the reasonableness and effectiveness of the Air Force's implementation plan and final report.
- Maintaining close coordination with the Air Force Audit Agency and using their data whenever possible, both to corroborate our work and to extend our scope. For example, we complemented our limited evaluation of base level internal control reviews with the Air Force Audit Agency's more comprehensive evaluation.

Our review was initiated in July 1983. As stated above, our emphasis was on evaluating the Air Force process for implementing the act during the first year. We did not independently determine the status of the Air Force's internal controls or the extent to which its accounting systems were in compliance with the Comptroller General's principles and standards.

Our review was made in accordance with generally accepted government auditing standards.

EXTRACTS FROM THE AIR FORCE REPORT
ON MATERIAL WEAKNESSES AND ACCOUNTING
SYSTEM COMPLIANCE PLANS

The following are extracts from the Air Force's 1983 report to the Secretary of Defense. The report identified four areas having material weaknesses requiring corrective action and six accounting systems that do not fully comply with the Comptroller General's accounting principles and standards.

WEAKNESSES REQUIRING CORRECTIVE ACTION

Foreign Military Sales (FMS). The Air Force now manages over 4,000 cases, representing more than 75 countries or international organizations who have roughly \$46 billion involved. Our concerns in this area are well documented by various oversight units. Financial management within the FMS program needs, and is getting, increased attention within the Air Force. The more important tasks we are addressing include: developing management systems to meet FMS needs; fixing responsibilities and eliminating overlaps or redundancies in policy, practice, etc.; establishing a central function to review performance of case managers, country/services, command performance or Air Force trends; and enhancing the sense of individual responsibility at all management levels.

Spare Parts Acquisition. During the period, FY 79-82, the Air Force was actively investigating the causes for the apparent sharp increases in prices paid for certain spare parts. A series of internal studies and investigations beginning in 1979 resulted, late in 1982, in a public disclosure of an Air Force Logistics Command report on engine spare parts price increases. This disclosure led to a series of Congressional hearings and a media coverage which highlighted the issue to the general public. We fully appreciate the urgent need to effect early and tangible improvements in this area.

Weapon System Acquisition. Air Force shares your and the public's concern regarding the way we manage our weapon system acquisitions. We believe the Air Force is making significant progress in addressing program cost growth weaknesses by means of baselining/cost capping, improved cost reporting, and

increased use of Independent Cost Analyses (ICAs). In addition, our competition and multiyear procurement initiatives are aimed at more efficient utilization of budgeted dollars.

Payroll Operations. Some of the payroll operations of our accounting and finance system require manual processing to provide efficient service to members and meet the requirements of directing authorities. The Joint Uniform Military Pay System's computer programs are not adequately documented making current modifications difficult. The Retiree/Annuitant Pay System has incomplete audit trails. We have an aggressive program to remedy these deficiencies.

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ACCOUNTING SYSTEM COMPLIANCE PLANS

1. General Accounting and Finance System
 - a. Develop and implement depreciation and total costing
 - b. Develop and implement capability to account for, and report, contingent liabilities
 - c. Redesign the general accounting and finance system adopting transaction-by-transaction posting to the general ledger
 - d. Redesign as paragraph c. above to incorporate property accounting feature
 - e. Modify base processing routines and records to accept AFCMD/DCASR [Air Force Contract Management Division and Defense Contract Administrative Service Region] input
2. Defense Integrated Financial System for Foreign Military Sales
 - a. Revise the system of assignment and control of computer passwords
 - b. Establish a special team to reconcile the FRB Korean Interest Bearing Account

3. Air Force Stock Fund - Departmental Level
 - a. Provide capability to record estimates of accounts receivable in the departmental system
 - b. Develop procedures for computing estimates
4. Central Procurement Accounting Systems
 - a. Initiate project study to account for Government-furnished material
 - b. Provide tasking and guidelines to Logistics Command headquarters to record accrued expenditures unpaid
5. Joint Uniform Military Pay System
 - a. Establish and publish procedures to manage advance payments
 - b. Develop and implement systems changes for a permanent appellate leave code
 - c. Modify system to extract data for accounts receivable report
 - d. Revise the JUMPS accounting system to provide data for VHA, Pro Pay [Variable Housing Allowance, Professional Pay], Medical Officer Incentive Pay, and Reenlistment Bonuses
6. Air Force Retiree/Annuitant Pay System
 - a. Implement changes to Annuitant System
 - b. Implement changes to Retiree System

ACTIVITIES VISITED BY GAOMajor Field Headquarters

Air Training Command
San Antonio, Texas

Strategic Air Command
Omaha, Nebraska

Military Airlift Command
Bellville, Illinois

Space Command
Colorado Springs, Colorado

Logistics Command
Dayton, Ohio

Communications Command
Bellville, Illinois

Accounting and Finance
Center
Denver, Colorado

Army/Air Force Exchange
Service
Dallas, Texas

Commissary Service
San Antonio, Texas

Base Level Activities

Randolph Air Force Base
San Antonio, Texas

Offutt Air Force Base
Omaha, Nebraska

Lackland Air Force Base
San Antonio, Texas

Scott Air Force Base
Bellville, Illinois



COMPTROLLER

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

27 MAR 1984

Mr. Frank C. Conahan
Director, National Security
and International Affairs
Division
General Accounting Office
441 G Street, NW, Room 4804
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "The Air Force's First Year Implementation of the Federal Managers' Financial Integrity Act," dated March 12, 1984 (GAO Code No. 390002), OSD Case No. 6468.

In its review, the GAO acknowledged progress. The DoD appreciates the assistance and cooperation during its review. The GAO personnel were extremely helpful in identifying and resolving problems encountered in the first year. DoD looks forward to a similar productive effort in the second year of implementation of the Act.

DoD comments on each finding and recommendation are provided in the Enclosure. The Department appreciates the opportunity to comment on the Draft Report.

Sincerely,


John R. Quetsch
Principal Deputy Assistant Secretary of Defense
(Comptroller)

Enclosure

DoD Comments
on

GAO Draft Report, "The Air Force's First Year Implementation of the Federal Managers' Financial Integrity Act," dated March 12, 1984 (GAO Code No. 390002), OSD Case No. 6468

GAO FINDING A

Numerous internal control reviews but ADP coverage limited. (p. 5, Draft Report) [See p. 3, this report]

DoD COMMENT

Concur.

GAO FINDING B

Identification of material weaknesses should be more specific. (p. 6, Draft Report) [See p. 3, this report]

DoD COMMENT

Concur.

GAO FINDING C

Accounting systems evaluations should be more comprehensive. (There was no recommendation.) (p. 7, Draft Report) [See p. 4, this report]

DoD COMMENT

Concur. DoD agrees with the basic concepts of the GAO comments. As stated in the Draft Report, the Air Force Comptroller's office plans to develop a comprehensive systems inventory, prepare written policies and procedures, and conduct more detailed system evaluations.

GAO FINDING D

Army and Air Force Exchange Service (AAFES) should report under the Act. In the GAO report to the Secretary of Defense, (GAO/NSIAD 84 __, "The Department of Defense's First Year Implementation of the Federal Managers' Financial Integrity Act," May 1, 1984), it will be recommended that the Exchange Service be required to follow the provisions of the Act and that either the Army or the Air Force be given permanent responsibility for the Exchange Service's internal control evaluation program. (p. 8, Draft Report) [See p. 4, this report]

DoD COMMENT

Concur. DoD will take the following implementing actions:

a. DoD Directive 7040.6, implementing the Federal Managers' Financial Integrity Act, will include nonappropriated fund instrumentalities as a matter of policy. It is anticipated that this revised Directive will become effective April 30, 1984.

b. The responsibility for AAFES will remain with the Air Force until August 1985 for purposes of consistency of reporting. On March 21, 1984, the Assistant Secretary of Defense (MI&L) requested the Secretaries of the Army and Air Force to make a permanent assignment of responsibility for the purpose of fulfilling the requirements of the Directive.

GAO RECOMMENDATION 1

That the Secretary of the Air Force direct the Comptroller of the Air Force to amend the second year guidance to ensure that automatic data processing controls are evaluated during internal control reviews involving automated areas. (p. 6, Draft Report)

[See p. 5, this report]

DoD COMMENT

Concur. On March 14, 1984, the Acting Assistant Secretary of the Air Force (Financial Management) directed implementation. The Comptroller of the Air Force staff is working with Air Staff functional managers and the Air Force Data Systems Design Center to amend second year guidance in consonance with GAO recommendations.

GAO RECOMMENDATION 2

That the Secretary of the Air Force disclose the specific weakness or problem in all future reports on internal control weaknesses. (p. 7, Draft Report)

[See p. 5, this report]

DoD COMMENT

Concur. On March 14, 1984, the Acting Assistant Secretary of the Air Force (Financial Management) directed implementation. The Air Force Fiscal Year 1984 annual statement on internal controls, prepared for the Secretary of Defense, will provide more definitive explanations of material weaknesses.

GLOSSARY

The following definitions were developed by GAO for our review of the implementation of the Federal Managers' Financial Integrity Act.

Accounting System

The total structure of the methods and procedures used to record, classify, and report information on the financial position and operations of a governmental unit or any of its funds, or organizational components. An accounting system should assist in the financial management functions of budget formulation and execution, proprietary accounting and financial reporting.

Administrative Function

An activity in an agency which is carried out to support the accomplishment of an agency's programs, missions, or objectives. These activities may include ADP, travel, or consulting services. However, there is no uniform definition of administrative functions; each agency's may be unique.

ADP Application Controls

Controls that are unique to each software application system. Application controls are intended to assure the quality of data origination, input, processing, and output.

ADP General Controls

Controls that apply to the overall management of the ADP function in an agency. General ADP controls have a direct effect on the quality of service rendered to ADP users and cover the processing of all ADP application systems. These controls affect most ADP hardware and application software systems, and include

- organizational controls for the ADP unit;
- system design, development, and modification controls;
- data center management controls;
- data center security controls;
- system software controls; and
- hardware controls.

These controls should be evaluated by ADP managers as part of an analysis of the general control environment.

Agency Component

A major organization, program, or functional subdivision of an agency having one or more separate systems of internal control, and a specific, responsible manager.

Assessable Unit

A program or administrative function or subdivision thereof, which is to be the subject of a vulnerability assessment. An agency should identify its assessable units in such a way as to (1) include the entire agency and (2) facilitate meaningful vulnerability assessments. All agency programs or administrative functions must be assessed, with the exception of those involved in the performance of policymaking or statutory formulation.

Audit Resolution

Begins when auditors report their findings to management and completed only after management takes action. Management must either correct identified deficiencies, produce improvements, or demonstrate that findings are invalid. "Audit Resolution" is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Control Objective

A desired goal or condition for a specific event cycle, system, or subsystem. An agency's control objectives should be developed for each agency activity and should address the three objectives in the Federal Managers' Financial Integrity Act. An example of a control objective may be "Paychecks should be issued to all, and only, entitled persons." "Control Objectives" are one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Control Technique

Any mechanism relied on to efficiently and effectively accomplish a control objective. These mechanisms, if operating as intended, help prevent fraud, waste, abuse, or mismanagement. An example of a control technique might be the comparison of automated personnel and payroll master files prior to computing and issuing paychecks. "Control Techniques" are one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Documentation

That information which would allow an independent reviewer to reach the same conclusions as the original reviewer regarding an agency's internal controls; and the methods used, personnel involved, and conclusions reached in conducting its internal control evaluation, improvement, and reporting process. This information should be current and be available for review. "Documentation" of internal controls is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Event Cycle

A grouping of similar activities. An entity's activities can be grouped into a discrete number of cycles. These groupings are based on what is accomplished, and therefore facilitate the identification of cycle objectives. For example, most agencies will have a disbursement cycle which will include all events contributing to the objective of providing reasonable assurance that all payments are legal, proper, accurate, and timely.

General Control Environment

Those environmental factors that can influence the effectiveness of internal controls over program and administrative functions. An evaluation of the general control environment is the first step in the vulnerability assessment process required by OMB's Guidelines.

This evaluation may be performed for the component as a whole, or individually for each program and administrative function within the component. The determining factors would be the size, nature, and degree of centralization of the programs and functions conducted within the agency component.

Inherent Risk

The inherent potential for waste, loss, unauthorized use, or misappropriation due to the nature of an activity itself. An analysis of each assessable unit's inherent risk is the second step in the vulnerability assessment process required by OMB's Guidelines. OMB's Guidelines suggest that the matters to be considered in the analysis should include, but need not be limited to, the following: purpose and characteristics, budget level, impact outside the agency, age and life expectancy, degree of centralization, special concerns, prior reviews, and management responsiveness.

Internal Controls

The plan of organization and all coordinate methods and measures adopted by an agency to provide reasonable assurance that the three objectives of the Federal Managers' Financial Integrity Act of 1982 are achieved. Internal controls should be established in accordance with the Comptroller General's Internal Control Standards. Typically, an internal control represents the combination of a control objective, along with a control technique (or set of techniques) which are being relied on to achieve that control objective.

Internal Control Review

A detailed examination of a system of internal control to determine whether adequate control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost effective manner. OMB's Guidelines recommend six steps for an internal control review: (1) identification of the event cycle, (2) analysis of the general control environment, (3) documentation of the event cycle, (4) evaluation of internal controls within the cycle, (5) testing of the internal controls, and (6) reporting the results. Internal control reviews should normally be conducted for those areas rated as highly vulnerable in the vulnerability assessment process, where corrective action is not readily apparent. An agency should allocate resources for these detailed reviews of internal control based on vulnerability; those most vulnerable should be reviewed first.

Internal Control Standards

In 1983, the Comptroller General issued a set of Standards For Internal Controls In The Federal Government. The Federal Managers' Financial Integrity Act of 1982 requires each executive agency to establish internal accounting and administrative controls in accordance with these standards. There are five general standards, six specific standards, and one audit resolution standard. The five general standards are: (1) reasonable assurance, (2) supportive attitude, (3) competent personnel, (4) control objectives, and (5) control techniques. The six specific standards are: (1) documentation, (2) recording of transactions and events, (3) execution of transactions and events, (4) separation of duties, (5) supervision, and (6) access to and accountability for resources.

OMB Guidelines

The document issued by the Office of Management and Budget in December 1982, Guidelines for the Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government. An evaluation conducted in accordance with these guidelines is to provide a basis for an agency's annual statement required by the act.

Preliminary Evaluation of Safeguards

A judgment regarding the existence and adequacy of internal control over an assessable unit. This evaluation is the third step in the vulnerability assessment process required by the OMB Guidelines. The evaluation is preliminary in that a more in-depth review of internal controls is the focus of the internal control review phase. The preliminary evaluation of controls required here should be based largely on the evaluator's working knowledge of the existence and functioning of internal controls in the subject assessable unit.

Program

Generally, an organized set of activities directed toward a common purpose or goal, and undertaken or proposed by an agency in order to carry out its responsibilities. In practice, however, the term "program" has many meanings. It is used to describe the agency's mission, functions, activities, services, projects, and processes.

Quality Assurance

The process(es) or system(s) of an agency which provide reasonable assurance that the internal control evaluation, improvement, and reporting process established in accordance with the OMB Guidelines is carried out in a consistent, accurate, and reliable manner. These processes or systems will form part of the basis for the annual assurance letters, and statement to the President and the Congress. An agency's quality assurance has several essential elements, including appropriate documentation for the internal control evaluation process, appropriate IG role in the process, adequacy of resources and overall organization of the process, appropriate training for managers with internal control responsibilities, and assuring that actions taken will correct weaknesses permitting fraud, waste, or mismanagement.

Reasonable Assurance

Internal control systems should provide reasonable, but not absolute, assurance that the objectives of the system will be accomplished. This concept recognizes that the cost of internal control should not exceed the benefit expected to be derived therefrom, and that the benefits consist of reductions in the risks of failing to achieve stated objectives. Estimates and judgments are required to assess the expected benefits and related costs of internal controls. Errors or irregularities may occur and not be detected because of inherent limitations in any internal control, including those resulting from resource constraints, or congressional restrictions. "Reasonable Assurance" is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Segmentation

The process by which an agency identifies its assessable units; i.e., its programs and administrative functions. The inventory of assessable units developed as a result of this process must be appropriately detailed so as to provide a basis for the conduct of meaningful vulnerability assessments. The OMB Guidelines provide that all the agency activities, except those concerned with policymaking, should be included in the inventory.

There is no single best method to segment an agency, particularly in light of variations in agency organization structure and responsibilities.

Specific Risk

A judgment regarding the likelihood and magnitude of error or irregularity in the event cycle being evaluated. These judgments represent an essential element of the fourth step recommended by OMB in its Guidelines for an internal control review: "Evaluation of the internal controls within the event cycle." The judgment regarding specific risk is based on a comparison of control objectives with related control techniques. Based on this evaluation, the amount and type of control testing, OMB's fifth step in an internal control review, will be determined.

Testing

The examination of available evidence to determine whether internal controls are functioning as intended. Testing is the fifth step recommended in OMB's Guidelines for the performance of an internal control review.

The nature of the controls, the significance of the cycle, importance of control objective, the nature of the specific risks, possible compensating controls, testing resources, and timing must all be considered in developing appropriate tests. Generally, testing can be categorized as either "compliance" or "substantive." Compliance testing is generally used when the judgment regarding specific risk has given reason to rely on a control technique. It is designed to verify if one or more internal control techniques are operating. The other category of testing, "substantive" testing, is used when the specific risk is sufficiently great that the control cannot be relied on. A substantive test is designed not to verify the operation of a control technique but rather to verify the results of the process to which the control was applied.

Vulnerability Assessment

A biennial review of the susceptibility of an assessable unit to the occurrence of waste, loss, unauthorized use, or misappropriation. OMB's Guidelines prescribe three basic steps for the conduct of vulnerability assessment: (1) analyze the general control environment, (2) analyze the inherent risk, and (3) perform a preliminary evaluation of existing safeguards.

The primary purpose of vulnerability assessments is to determine if and in what sequence resources should be allocated for the performance of internal control reviews.

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