United States General Accounting Office

GAO

Report to the Secretary of Defense

January 2003

DEFENSE BUDGET

Improved Reviews Needed to Ensure Better Management of Obligated Funds

GAO

Accountability * Integrity * Reliability

GAO-03-275

January 2003

GAO
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-03-275, a report to the Secretary of Defense

DEFENSE BUDGET

Improved Reviews Needed to Ensure Better Management of Obligated Funds

Why GAO Did This Study

As of September 30, 2001, the Navy's operating appropriations had $2.1 billion in unliquidated—or unpaid—funds that were obligated during fiscal years 1997-99. Unliquidated obligations that are no longer needed to pay for goods and services tie up funds that could be used for other permissible purposes. In addition, inaccurate obligation data result in misstatement of budgetary information.

Because of the large dollar value, we examined the Navy's management of unliquidated obligations. Specifically, we reviewed a statistically representative sample of the Navy's $1.4 billion in unliquidated operating obligations valued at $50,000 or more for fiscal years 1997-99 to determine whether these obligations were (1) properly accounted for and (2) reviewed in accordance with DOD regulations.

What GAO Recommends

We are recommending that the Navy adhere to obligation review regulations and better apply existing internal controls to ensure fund managers adhere to these regulations and are accountable for accuracy and completeness. The Navy partially concurred, but stated that it prioritizes obligation reviews to enable it to also pursue other efforts to improve financial reporting. We note that DOD regulations require review of all unliquidated obligations and do not allow for prioritization.

www.gao.gov/cgi-bin/getrpt?GAO-03-275.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Sharon Pickup at (202) 512-9619 or pickups@gao.gov.

What GAO Found

We estimated that $929 million of the $1.4 billion in unliquidated operating obligations valued at $50,000 or more for fiscal years 1997-99 was not properly accounted for (see table). Specifically, the Navy failed to deobligate $452 million of unliquidated operating obligations that was no longer needed and potentially available for other permissible purposes, such as contract modifications. In addition, $147 million of unliquidated operating obligations was inaccurately recorded because of problem disbursements—payments not properly matched to the correct obligation. A further $330 million was inaccurately recorded due to unresolved errors, such as bills that were not processed properly. The remaining $489 million in unliquidated operating obligations was properly accounted for and still needed for the original purpose.

An estimated two-thirds of the unliquidated operating obligations over $50,000 were not properly accounted for as a result of the Navy's failure to review such obligations three times each year as required by DOD regulations. In addition, the Navy did not fully adhere to the regulation that unliquidated operating obligations of any value be reviewed at least once each year. Consequently, the Navy did not know how much money was tied up in unliquidated operating obligations that could potentially be used for other appropriate needs, and its budgetary reports to Congress and financial statements were inaccurate. Navy fund managers chose to selectively review their operating obligations, citing obstacles such as difficulties in obtaining accurate payment and billing data and the extensive length of time needed to review large numbers of obligations. Further, the Navy did not apply existing internal control activities to ensure that fund managers performed obligation reviews in accordance with DOD regulations, nor did it hold fund managers accountable for the accuracy and completeness of the reviews.

Estimate of Navy's Unliquidated Operating Obligations Valued at $50,000 or More for Fiscal Years 1997-99, as of September 30, 2001

Dollars in millions

Category	Estimated total	Percentage of total
Still needed for original purpose	$489	35
Not properly accounted for:		
No longer needed for original purpose	452	32
Problem disbursements	147	10
Unresolved errors	330	23
Subtotal not properly accounted for:	929	65
Total	**$1,419**[a]	**100**

Source: DOD.
Note: GAO analysis of DOD data.
[a] Amounts do not add to total due to rounding.

Contents

Letter 1

Results in Brief 2
Background 4
Navy Did Not Properly Account for Large Portion of Unliquidated Operating Obligations 6
Navy Did Not Fully Adhere to DOD Review Regulations 9
Conclusions 11
Recommendations for Executive Action 12
Agency Comments and Our Evaluation 12

Appendix I **Scope and Methodology** 16

Appendix II **Agency Comments** 19

Appendix III **GAO Contacts and Staff Acknowledgments** 21

Tables

Table 1: Estimate of Navy's Unliquidated Operating Obligations for Fiscal Years 1997-99, as of September 30, 2001 7
Table 2: Dollar Value Distribution of Fiscal Year 1997-99 Obligations Reviewed in the GAO Sample, as of September 30, 2001 17

Abbreviations

DOD Department of Defense
FMR Financial Management Regulations

G A O
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

January 30, 2003

The Honorable Donald H. Rumsfeld
Secretary of Defense

Dear Mr. Secretary:

The Department of Defense (DOD) confronts pervasive and complex financial management problems that can seriously diminish the efficiency of the military services' support operations. Recent audits of DOD's financial statements highlight ongoing financial management challenges that affect the development of accurate and complete financial information. Among the challenges facing DOD is the lack of accurate obligation data needed for effective budget management and reliable financial reporting.

To ensure accuracy, it is important for the services to liquidate obligations if funds are no longer needed as originally planned and adjust their financial records accordingly. Unliquidated obligations are those that have not yet been paid. The unliquidated obligations that are no longer needed to pay for goods and services tie up funds that could be used for other permissible purposes. Inaccurate obligation data result in misstatement of budgetary information on federal financial statements and in the President's budget and contribute to the failure to provide basic financial accountability.[1]

DOD has recognized the need for the services to identify and reduce the number and amount of unliquidated obligations by requiring that fund managers review these obligations. In 1996, the DOD Office of the Under Secretary of Defense (Comptroller) issued a memorandum directing DOD components to review three times each year the accuracy of unliquidated operating obligations valued at $50,000 or more. DOD also directed agencies to review all other unliquidated operating obligations at least once a year. In reviewing service obligation data, we noted that the Navy has significantly large amounts of unliquidated obligations. As of

[1] "Providing basic financial accountability" has been identified by GAO as a governmentwide high-risk area in need of attention. See U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: Jan. 2001).

September 30, 2001, the Navy's operating appropriations[2] had $2.1 billion in unliquidated funds that were obligated during fiscal years 1997-99, of which $1.4 billion (67 percent) represented unliquidated operating obligations of $50,000 or more.[3] Also, in 1999 and 2000, Navy auditors reported inaccuracies in the Navy's obligation data and found that fund managers were not fully complying with DOD review regulations.

Because of the large dollar value of unliquidated obligations and Navy audit findings, we reviewed the Navy's management of its unliquidated operating obligations. More specifically, we determined whether these unliquidated operating obligations were (1) properly accounted for and (2) periodically reviewed in accordance with DOD regulations. We reviewed a statistically representative sample of the Navy's unliquidated operating obligations of $50,000 or more for fiscal years 1997-99. We also analyzed documentation related to DOD's obligation review regulations and the Navy's guidance to adhere to the regulations, and interviewed Navy officials. A more detailed description of our scope and methodology is included in appendix I.

Results in Brief

On the basis of our sample, we estimated that $929 million of the $1.4 billion in unliquidated operating obligations valued at $50,000 or more for fiscal years 1997-99 was not properly accounted for. Specifically, the Navy failed to deobligate $452 million of unliquidated operating obligations that was no longer needed and potentially available for other permissible purposes, such as contract cost overruns or contract modifications. In addition, $477 million of unliquidated operating obligations was not properly accounted for due to billing and recording errors. For example, payments were made and recorded on behalf of the wrong obligation, or payments were not made because bills were not processed properly. In addition to tying up funds unnecessarily, these obligation errors resulted in inaccurate reporting in the Navy's budgetary reports and in its financial statements. The remaining $489 million in unliquidated operating obligations was properly accounted for and still needed for the original purpose.

[2] "Operating" appropriations include the Operation and Maintenance (O&M), Defense-wide, and Defense Health Program appropriations.

[3] The Navy obligated a total of $25.6 billion in operating funds during fiscal years 1997-99, as reported in its Standard Accounting and Reporting System, which maintains approximately 90 percent of all operating appropriation obligations.

An estimated two-thirds of the unliquidated operating obligations over $50,000 were not properly accounted for as a result of the Navy's failure to review such obligations three times each year as required by DOD regulations. In addition, the Navy did not fully adhere to the regulation that unliquidated operating obligations of any value be reviewed at least once each year. Consequently, the Navy did not know how much money was tied up in unliquidated operating obligations that could potentially be used for other permissible needs, and its budgetary reports to Congress and financial statements were inaccurate. Navy fund managers chose to selectively review their operating obligations, citing obstacles such as difficulties in obtaining accurate payment and billing data and the extensive length of time needed to review large numbers of obligations. Further, the Navy did not apply existing internal control activities to ensure that fund managers performed obligation reviews in accordance with DOD regulations, nor did it hold fund managers accountable for the accuracy and completeness of the reviews.

Accordingly, we are recommending that the Navy adhere to its obligation review regulations and apply existing internal controls to ensure fund manager adherence to these regulations. The Navy partially concurred with our recommendations, acknowledging that more thorough efforts dedicated to the review of obligations would increase the accuracy and reliability of financial reports. The Navy, however, noted that because numerous factors contribute to problems in financial reports, it has to prioritize its remedial efforts and therefore focus on reviewing unliquidated obligations in available appropriations, correcting systemic problems, and pursuing broad improvements in financial management. When appropriate requirements have arisen, the Navy commented that encumbrances for unliquidated obligations have not been an impediment to obtaining necessary funds. While we agree focusing on systemic issues offers opportunities to improve the Navy's financial information, we note DOD's obligation review regulations are in fact designed to minimize systemic problems and do not allow for prioritization. Furthermore, the ability of the Navy to gain access to funds when needs arise does not relieve it of the responsibility to adhere to existing laws and regulations governing sound financial management. We therefore are making no changes to the recommendations in our report.

Background

Obligations are recorded when an authorized agent of the federal government enters into a legally binding agreement to purchase specific goods or services.[4] As bills are received and payments are made, the recorded obligation is reduced by the amount of the payments made. When all services or goods have been received and paid for, the obligation is considered "liquidated," and any remaining amount of the unliquidated (unpaid) obligation should be deobligated and reduced to zero.[5] Operating funds must be obligated in the fiscal year for which they are appropriated. However, obligated funds may be spent over a period of 5 additional years, as bills for goods and services are received and paid.[6] If the goods and services are received and paid for in the first year of the obligation, the remaining unliquidated obligation can be reused for other needs consistent with the source appropriation. If the goods and services are received and paid for in the subsequent 5 years, the remaining unliquidated obligation can still be used, if permissible, to modify contracts or to increase existing obligations that might need more funds.

Accurate obligation information is essential for reliable budgeting reports to Congress, agency financial statements, performance measurements, and funds control. Inaccurate obligation data misstates the amount of funds available from the appropriation, contributes to inaccuracies in the Navy's budget and financial reports, and subsequently leads to inaccuracies in federal financial statements. For example, the Navy's unliquidated obligations are reported in the Navy Statement of Budgetary Resources, which are in turn incorporated in other DOD and federal budget reports and financial statements.

We have documented weaknesses in DOD's accounting practices and Navy auditors have documented inaccuracies in the Navy's obligations data. In our 2001 Performance and Accountability Series report, we stated that because of weaknesses in DOD's budget execution accounting, the department does not know with certainty the amount of funding it has

[4] 31 U.S.C. 1501; DOD Financial Management Regulation (FMR) volume 3, chapter 8, section 080301.

[5] DOD FMR volume 3, chapter 8, section 080405 A, requires all deobligations, adjustments or corrections to be documented and processed within 10 working days of their identification.

[6] 31 U.S.C. 1552.

available.[7] Naval Audit Service reports published in February 1999[8] and January 2000[9] reported that Navy fund managers were not complying with obligation review regulations and documented inaccuracies in the Navy's obligation data. In July 2000 we reported that such inaccuracies in obligation data not only hamper DOD's ability to produce timely and accurate financial information, but also significantly impair efforts to improve the economy and efficiency of its operations.[10]

To ensure that obligation data are tracked and accurately reported, the DOD Financial Management Regulations (FMR) require that the services, including the Navy, review their unliquidated operating obligations valued $50,000 or more three times a year to ensure that they are accurate and that the funds are still needed.[11] All unliquidated operating obligations, regardless of dollar value, must be reviewed at least once a year.[12] Also, Congress specifically established in chapter 15 of title 31, United States Code, a framework for reviewing, adjusting, certifying to, and reporting on, among other items, the status and amounts of unliquidated obligations.[13] In addition, for many interagency obligations entered under specific statutory authority, such as the Economy Act,[14] the authorizing

[7] U.S. General Accounting Office, *High Risk Series: An Update*, GAO-01-263 (Washington, D.C.: Jan. 1, 2001).

[8] Naval Audit Service, *Obligations Associated Primarily with Indefinite Delivery Contracts and Basic Ordering Agreements* (Falls Church, Va.: February 18, 1999).

[9] Naval Audit Service, *Validation of Selected Work Request Obligations in the Standard Accounting and Reporting System* (Washington, D.C.: Jan. 28, 2000).

[10] U.S. General Accounting Office, *Department of Defense: Implications of Financial Management Issues*, GAO/T-AIMD/NSIAD-00-264 (Washington, D.C.: July 20, 2000).

[11] DOD FMR volume 3, chapter 8, section 080403 B. DOD first implemented this requirement in May 1996 via a memorandum issued by the Office of the Under Secretary of Defense to all military services, including the Navy. DOD formally added the requirement to volume 3, chapter 8 of the FMR in November 2000.

[12] DOD FMR volume 3, chapter 8, section 080403 E.

[13] 31 U.S.C., chapter 15, subchapter IV. 31 U.S.C. § 1554(b) specifically directs heads of agencies to report to the President and the Secretary of the Treasury, and to certify to those reports, regarding unliquidated obligations and other balances and adjustments. Section 1554(c) directs agencies to establish controls to assure that an adequate review of obligated balances is performed.

[14] 31 U.S.C. § 1535.

statute may mandate the deobligation of appropriations at specific times or when certain conditions arise.[15]

The DOD regulation also directs the services to implement effective internal controls to ensure that the required reviews are completed and that identified corrective actions are completed in a timely manner.[16] Further, the Federal Managers' Financial Integrity Act of 1982[17] requires that agencies' controls reasonably ensure that (1) obligations and costs comply with applicable law and (2) revenues and expenditures applicable to agency operations are properly recorded and accounted for so that agency accounts and reliable financial and statistical reports may be prepared and the accountability of assets may be maintained.[18]

Navy Did Not Properly Account for Large Portion of Unliquidated Operating Obligations

An estimated two-thirds of the Navy's unliquidated operating obligations valued at $50,000 or more from the fiscal years 1997-99 operating appropriations was not properly accounted for. Specifically, we estimated that $929 million of the $1.4 billion in unliquidated operating obligations was not properly accounted for. As shown in table 1, $452 million of the unliquidated operating obligations was no longer needed for its original purpose. These funds could have been used for other permissible purposes of the same appropriation and fiscal year, such as contract modifications. In addition, $477 million was not properly accounted for due to billing and recording errors, including $147 million in problem disbursements and $330 million in unresolved accounting and recording errors. Finally, $489 million in unliquidated operating obligations was properly accounted for and still needed for the original purpose.

[15] Section 1535(d) of the Economy Act, for example, requires deobligation of funds at the end of their period of availability if the performing agency has not performed or otherwise made authorized contracts.

[16] DOD FMR volume 3, chapter 8, section 080404.

[17] P.L. 97-255, § 2, 96 Stat. 814, September 8, 1982 (codified at 31 U.S.C. § 3512(b) and (c)), and is commonly called the Federal Managers' Financial Integrity Act of 1982.

[18] 31 U.S.C. § 3512(c)(1).

Table 1: Estimate of Navy's Unliquidated Operating Obligations for Fiscal Years 1997-99, as of September 30, 2001

Dollars in millions		
Category	**Estimated total**	**Percentage of total**
Still needed for original purpose	$489	35
Not properly accounted for:		
No longer needed for original purpose	452	32
Problem disbursements	147	10
Unresolved errors	330	23
Subtotal not properly accounted for:	929	65
Total	**$1,419**[a]	**100**

Source: DOD.
Note: GAO analysis of DOD data.

[a] Amounts do not add to total due to rounding.

The Navy failed to deobligate an estimated $452 million that was no longer needed for the original obligated purpose. According to DOD regulations, these unliquidated funds should have been deobligated once services had been performed, final payment issued, and the funds made available for other purposes consistent with the appropriation. In many of our sample cases, the entire amount of an obligation was not required to meet billing needs and resulted in funds remaining over. For example, in one of the cases we reviewed, $4.7 million had been disbursed from a 1997 obligation, valued at $6 million, to support the San Diego Harbor Tug Charter; however, the last disbursement was made in October 1999. We discovered that the remaining unliquidated funds were no longer needed and the Navy subsequently deobligated the unliquidated $1.3 million. Similarly, we reviewed a 1996 (fiscal year 1997) obligation to fund systems development at the Bureau of Naval Personnel. When the responsible Navy fund manager reviewed the unliquidated obligation at our request, he determined that the outstanding balance of $1.4 million attached to this obligation was no longer required and deobligated it. In both of these cases, if Navy personnel had reviewed these obligations in accordance with DOD regulations, they would have detected the error and deobligated the funds years ago, thereby possibly allowing Navy to use the funds for other permissible purposes, including contract modifications, or other obligation needs of the same appropriation and fiscal year.

The Navy had also not properly accounted for an estimated $147 million in unliquidated operating obligations due to expenditures that were not properly matched to a specific obligation recorded in the Navy's records—problem disbursements. We previously reported that the Navy's financial

control policy and procedures do not ensure that the Navy can match payments to corresponding obligations before or at the time a payment is made.[19] Consequently, if the Navy cannot resolve these problem disbursements by matching the disbursement to the original obligation, it must record a new obligation to cover the disbursement after a payment is made. For example, one of our sample items had an unliquidated obligation balance of $1,362,790 on September 30, 2001. The fund manager of this 1998 obligation stated that all of the funds had been disbursed; however, the Navy's Standard Accounting and Reporting System indicated that no disbursements had been made. We discovered that in fact all of the funds had been disbursed for this obligation, but the disbursements had been posted to the wrong obligation in the accounting system. Funds that remain unliquidated due to a problem disbursement may not be deobligated and used for other purposes because the funds are still needed to reimburse the obligation that was erroneously charged for the disbursement.

The Navy had not properly accounted for an estimated $330 million due to unresolved accounting and recording errors. These obligations remained unliquidated for several reasons. Most unresolved errors in our sample occurred because fund managers were unable to identify whether the providers of goods or services had been paid in full for services rendered. The fund managers claimed that providers were often slow to bill or had not sent a final bill. For example, we reviewed a 1997 obligation for aircraft maintenance that had an unliquidated balance of $14.4 million. The fund managers said that they had not received a bill from the Air Force, which provided the maintenance service. In this case, the $14.4 million remained on the books as unresolved, because the fund managers still expected to receive a bill for the services. An example of a recording error is illustrated in a $12 million obligation to support alterations on the USS LaSalle. A disbursement was input twice and then reversed twice instead of once. The second reversal of the disbursement left an unliquidated balance on the obligation that should have been disbursed. Funds that remain unliquidated due to unresolved accounting and recording errors cannot be deobligated and used for other purposes, because the Navy needs to have funds available to pay providers after the errors have been resolved.

[19] U.S. General Accounting Office, *Financial Management: Problems in Accounting for Navy Transactions Impair Funds Control and Financial* Reporting, GAO/AIMD-99-19 (Washington, D.C.: Jan. 19, 1999).

Navy Did Not Fully Adhere to DOD Review Regulations

The Navy did not fully adhere to DOD regulations to review all unliquidated operating obligations, including those obligations valued at $50,000 or more three times per year and those obligations valued at less than $50,000 once every year. Furthermore, the Navy did not utilize internal controls to determine the accuracy of the review process or the outcomes of the reviews. As a result, the Navy did not know how much money was tied up in unliquidated operating obligations that could potentially be used for other permissible needs.

According to DOD regulations, obligation reviews are to be conducted by fund managers within 14 days following the end of January, May, and September. DOD regulations also require the services to implement effective internal controls to ensure that the reviews are completed and corrective actions are implemented in a timely manner. The purpose of these reviews is to ensure that the unliquidated balances are accurate and still needed. The Navy issued implementing guidance that (1) restates the three deadlines provided in the DOD regulations, (2) requires that internal controls be implemented by each entity as described in DOD regulations, and (3) requires each fund manager to complete a checklist of the review steps performed. For example, one required step is to follow up and ensure the obligation is still needed. The guidance also requires the comptroller of each major command to consolidate the review results from the fund managers and include a list of all fund managers who did not fully adhere to DOD regulations and the reason why. The major command confirmation statement is to be forwarded to the Assistant Secretary of the Navy (Financial Management and Comptroller), Office of Budget.

Although DOD regulations require Navy fund managers to review all operating obligations once annually and those $50,000 and above three times each year, fund managers have not fully adhered. Fund managers stated that they selectively reviewed some unliquidated operating obligations, but were unable to make all the required reviews or complete all the steps on some of the cases they reviewed. For example, fund managers first prioritize for review the high-value unliquidated operating obligations in the current fiscal year to accommodate immediate funding requirements. That frees the funds for reobligation during the same fiscal year. Unliquidated operating obligations that are approximately 5 years old and, based on appropriations that will cancel at the end of the fiscal year, are also a high priority for review in order to pay outstanding bills while funds are available. As a result of prioritized and selective obligations review, some operating obligations are not reviewed three times a year as required by DOD regulations and some are not reviewed at all.

Navy fund managers provided several reasons why they selectively reviewed obligations and did not review all of them. They stated that the process of reviewing an obligation can be time-consuming due to a lack of automated tools and, often, a lack of accurate billing information needed to assess the validity of an obligation, especially for older obligations. Officials acknowledged that the Navy's Standard Accounting and Reporting System provides users with the capability to conduct ad hoc queries of the obligation database, but they claim these tools are not user-friendly because users must be familiar with the system's database-programming code to take full advantage of its capabilities. Few of the staff assigned to perform obligation reviews had the required computer training or knowledge to write queries. Some of the fund managers also told us that they were reluctant to review the large volume of low dollar unliquidated operating obligations because they felt the expected rate of return was not cost beneficial given the magnitude of resources required to conduct the review. To illustrate the large volume, Atlantic Fleet officials reported that they had 579,904 unliquidated operating obligations valued $50,000 or less,[20] and officials at the Pacific Fleet reported 724,266 such unliquidated operating obligations.[21] Further, some fund managers stated that it was impossible for them to comply with the requirement to review all such unliquidated operating obligations even once a year, because they did not have enough staff to review the large number of such obligations.

Officials in the Navy Comptroller Office acknowledged that fund managers have reported difficulties performing obligation reviews. Navy officials also acknowledged that inaccurate obligation data compromises the reliability of their financial statements, and therefore it is reasonable that they review their obligations according to the regulations. Consequently, the Navy has not sought relief from DOD obligation review regulations.

The Navy did not utilize internal control activities necessary to ensure that fund managers performed thorough obligation reviews in accordance with DOD regulations. Although some major commands had developed written standard operating procedures or checklists to track whether fund managers had reviewed their unliquidated operating obligations, they did not hold managers accountable for the accuracy and completeness of the reviews. Fund managers submitted obligation-review confirmation

[20] As of Mar. 10, 2002.

[21] As of June 14, 2002.

statements to their major commands, but often the commands could not determine specific details about the obligations, including the number of unliquidated operating obligations reviewed, the amount of the obligations reviewed, and the resolution of any problems identified during the review. For example, one major command has a process to review whether fund managers submit the required obligation review paperwork. However, the command does not spot-check obligations to determine if they are valid as claimed by the fund managers and accepts the fund managers obligations review paperwork as is.

Officials in the Navy Comptroller Office stated that fund managers should place more emphasis on reviewing obligations in accordance with DOD regulations. However, they did not think it would be productive to discipline fund managers for failure to adhere to the regulations. Rather, they believe that the Navy should rely on financial system upgrades to improve the accuracy of obligation data.

Conclusions

As highlighted in our 2001 Performance and Accountability Series reports, financial management is one of the major management challenges facing DOD.[22] The large dollar value of unliquidated Navy obligations that were not properly accounted for contributes to inaccuracies in the Navy's budget and financial reports, and subsequently leads to inaccuracies in federal financial statements and the President's budget. Moreover, the Navy will not be able to pass the test of an independent financial audit until it corrects inaccurate obligation data.

DOD regulations and Navy guidance provide for unliquidated obligations to be reviewed by fund managers on a regular basis. The fund managers' ability to deobligate or resolve the errors on many of our sample items demonstrates that the review process could be effective. But the fund managers have chosen to only selectively follow the requirements for review because they said they were constrained by too little time to review the large number of transactions, inaccurate billing information, and the lack of automated tools. Although the Navy recognized the potential benefits of timely identification of funds that are no longer needed or in error, its internal controls have not ensured that required reviews were made and corrective action taken. We note that fund managers were able

[22] U.S. General Accounting Office, *High Risk Series: An Update*, GAO-01-263 (Washington, D.C.: Jan. 1, 2001).

to successfully resolve nearly all of the unliquidated operating obligations in our sample even though the resolution of some of the obligations required an extensive amount of time and effort. Therefore, it is likely that many of the unliquidated obligations in our sample that were not properly accounted for could have been identified and accounting errors could have been corrected prior to our review had fund managers performed obligation reviews in accordance with the DOD regulations.

Recommendations for Executive Action

We recommend that the Secretary of Defense direct the Secretary of Navy to:

- adhere to DOD unliquidated operating obligation review regulations; and
- better apply existing internal control activities to ensure adherence to these regulations, and to hold fund managers accountable for the accuracy and completeness of their reviews.

As you know, 31 U.S.C. requires the head of a federal agency to submit a written statement of the actions taken on our recommendations to the Senate Committee on Government Affairs and the House Committee on Government Reform not later than 60 days after the dare of this report. A written statement must also be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

Agency Comments and Our Evaluation

The Director, Office of the Budget, Department of the Navy provided DOD's written comments on a draft of this report, which are provided in their entirety in appendix II. The Navy partially concurred with our recommendations and noted that more thorough efforts dedicated to the review of obligations would increase the accuracy and reliability of financial reports. It also plans to make the review process a part of its management structure and stress the importance of accurate financial statements. The Navy, however, commented that because numerous factors contribute to problems in financial reports, it has to prioritize its remedial efforts. Specifically, the Navy places a premium on reviewing unliquidated obligations in available appropriations, correcting systemic problems, and pursuing broad improvements in financial management. For example, the Navy stated it made significant improvements in correcting systemic issues—such as problem disbursements—and is working to provide automated tools and correct systemic issues that would positively impact the fund managers' ability to conduct obligation reviews. While it noted validating unliquidated obligations is desirable and important, the

Navy emphasized that systemic improvement of its financial information offers the better opportunity for success.

The Navy did not agree that the difficulty the fund managers have had in reviewing unliquidated obligations precluded the use of funds for other appropriate needs. It noted that Congress has intentionally and progressively limited the availability of funds from prior year appropriations, clearly establishing that the appropriateness of use outweighs the efficiency of use. When appropriate requirements for the application of available funds from prior year appropriations have arisen, the Navy commented that encumbrances for unliquidated obligations have not been an impediment to obtaining necessary funds.

While we understand numerous factors, including systemic issues, affect the accuracy of Navy financial reports, DOD regulations require that fund managers annually review all unliquidated obligations and, as currently written, do not provide for prioritization of such reviews. We recognize the Navy has taken steps to significantly reduce the amount of outstanding problem disbursements; however, as our report points out, problem disbursements are only part of the reason for the significant amount of unliquidated obligations. For example, about $782 million of the $929 million in unliquidated obligations in our sample were improperly accounted for due to reasons unrelated to problem disbursements. Specifically, the aggregate of these transactions involved funds that were no longer needed for their original purpose or involved unresolved accounting and recording errors. While we agree that focusing on systemic issues offers opportunities to improve the Navy's financial information, we also note that the internal control procedures reflected in DOD's obligation review regulations are in fact designed to minimize systemic problems such as problem disbursements. To the extent that the Navy's efforts to make systemic improvements include automated tools designed to assist the fund managers in complying with obligation review requirements, we believe these efforts represent a positive step.

We disagree with the Navy's views regarding the impact of failing to review all unliquidated obligations as required under current DOD regulations. Regardless of whether the Navy is able to gain the funds necessary from unliquidated obligations to satisfy appropriate requirements as they arise, inaccurate obligation data in the Navy's financial system has broader implications, such as inaccurate financial reports and misstatements of budgetary information on federal financial statements and in the President's budget. While we agree Congress has placed statutory limitations on the availability of appropriated funds, DOD,

like all agencies, is responsible for effectively and efficiently implementing its activities within the limitations applicable to the appropriations it receives. Indeed, Congress specifically established in chapter 15 of title 31, United States Code, a framework for reviewing, adjusting, certifying to, and reporting on, among other items, the status and amounts of unliquidated obligations.[23] In addition, the Federal Managers' Financial Integrity Act of 1982[24] requires that agencies have controls to reasonably ensure that revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of assets may be maintained.[25] Finally, for many interagency obligations entered under a specific statutory authority—such as the Economy Act[26]—the authorizing statute may mandate the deobligation of appropriations at specific times or when certain conditions arise.[27] In this context, the ability of the Navy to access funds encumbered by unliquidated obligations does not relieve it of the responsibility to adhere to existing laws and regulations governing sound financial management. We therefore are making no changes to the recommendations in our report.

We are sending copies of this report to congressional committees with jurisdiction over DOD's budget and the Secretary of the Navy. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

[23] 31 U.S.C., chapter 15, subchapter IV. 31 U.S.C. § 1554(b) specifically directs heads of agencies to report to the President and the Secretary of the Treasury, and to certify to those reports regarding unliquidated obligations and other balances and adjustments. Section 1554(c) directs agencies to establish controls to assure that an adequate review of obligated balances is performed.

[24] P.L. 97-255, § 2, 96 Stat. 814, September 8, 1982 (codified at 31 U.S.C. § 3512(b) and (c)), and is commonly called the Federal Managers' Financial Integrity Act of 1982.

[25] 31 U.S.C. § 3512(c)(1).

[26] 31 U.S.C. § 1535.

[27] Section 1535(d) of the Economy Act, for example, requires deobligation of funds at the end of their period of availability if the performing agency has not performed or otherwise made authorized contracts.

If you or your staff have any questions about this report, please call me at (202) 512-9619. Key contributors to this report are listed in appendix III.

Sharon Pickup
Director, Defense Capabilities and Management

Appendix I: Scope and Methodology

Our objective was to determine whether the Navy's unliquidated operating obligations were (1) properly accounted for and (2) periodically reviewed in accordance with DOD regulations.

To determine whether Navy's unliquidated operating obligations were properly accounted for, we requested that the Defense Finance Accounting Office provide us with a database that identified all unliquidated operating obligations outstanding on September 30, 2001. We relied on the completeness and accuracy of that database based on the office's representations and did not independently test or reconcile the validity of their database. For our review, we selected unliquidated operating obligations for fiscal years 1997-99. Older obligations are more likely to be in error and thus provided a better test of the Navy's obligation management practices. We then divided the individual unliquidated operating obligations into two groups—those valued at less than $50,000 and those valued at $50,000 or more. Those valued at $50,000 or more represented $1.4 billion, or 67 percent of the value of all outstanding operating obligations for fiscal years 1997-99.

From the population of obligations valued at $50,000 or more, we drew a stratified random sample of 205 unliquidated operating obligations to review. For each transaction, we obtained the following documentation: (1) documentary support describing each obligation, including amendments and modifications for each sample transaction; (2) responses from Navy officials regarding whether each unliquidated operating obligation in our sample was still needed for its original purpose according to the criteria in the DOD Financial Management Regulation[1] (FMR); and (3) support for how to classify each unliquidated operating obligation in our sample as still needed, no-longer-needed, problem disbursement, or an unresolved accounting and recording error.

The sample was selected from three strata defined by the dollar value of the obligations, as shown in table 3.

[1] DOD FMR volume 3, chapter 8, section 080303 A.

Table 2: Dollar Value Distribution of Fiscal Year 1997-99 Obligations Reviewed in the GAO Sample, as of September 30, 2001

Strata	Number of items	Total value
Over $10,000,000	5	$240,382,914.38
$500,000 to $10,000,000	100	113,190,918.46
$50,000 to $499,999	100	14,571,125.75
Total	**205**	**$368,144,958.59**

Source: DOD.
Note: GAO analysis of DOD data.

To determine whether the amount of each unliquidated operating obligation was properly accounted for, we reviewed support provided by the Navy, discussed the status of the unliquidated obligation with the primary Navy official responsible for the individual transaction, and used the criteria set forth in DOD's regulations. We classified unliquidated operating obligation transactions as "still needed" and properly accounted for when the Navy provided documentation to support that the contracted goods or services were still needed; thus, the transaction passed a bona fide needs test. Items not properly accounted for fell into three categories. We classified the transaction "no longer needed for original purposes" when the Navy could not provide support that a bona fide need existed. We classified transactions as "problem disbursements" when specific disbursements were not properly matched to corresponding obligations recorded in the department's records. We classified the remaining unliquidated operating obligation transactions as "unresolved accounting and recording errors" when they did not clearly meet the criteria for needed, no-longer-needed, or problem disbursements.

To determine if the Navy's unliquidated operating obligations were periodically reviewed in accordance with DOD regulations, we requested that the Navy provide documentation and guidance on the Navy's implementation of the regulations. We also interviewed officials at 12 locations to discuss (1) their procedures for performing obligation reviews, (2) the magnitude of transactions involved to perform the review as set forth in the DOD obligation review regulations, and (3) whether the officials had difficulty meeting the obligation review requirements, including the reasons why. We visited the Commander in Chief of the Atlantic Fleet in Norfolk, Va.; the Commander, Navy Mid-Atlantic Region in Norfolk, Va.; the Commander, Naval Sea Systems Command in Washington, D.C.; the Naval Facilities Engineering Command in Washington, D.C.; the Director of Strategic Systems Programs in Washington, D.C.; the Commander in Chief of the Pacific Fleet in Pearl

Harbor, Hawaii; the Commander, Naval Region in Pearl Harbor, Hawaii; the Commander, Naval Air Force Command of the Pacific Fleet in San Diego, Calif.; the Commander, Naval Surface Force Command of the Pacific Fleet in San Diego, Calif.; the Space and Naval Warfare Systems Command in San Diego, Calif.; the Commander, Naval Air Systems Command in Patuxent River, Md.; and the Bureau of Medicine and Surgery in Washington, D.C.

We conducted our review from October 2001 through October 2002 in accordance with generally accepted government auditing standards.

Appendix II: Agency Comments

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, DC 20350-1000

DEC 13 2002

Ms. Sharon L. Pickup
Director, Defense Capabilities and Management
U.S. General Accounting Office
441 G. Street, N.W.
Washington, DC 20548

Dear Ms. Pickup,

This is the Department of Defense (DoD) response to the GAO draft report, "DEFENSE BUDGET: Improved Reviews Needed to Ensure More Efficient Use of Obligated Funds," dated November 8, 2002, (GAO Code 350126/GAO-03-275).

The Department of the Navy (DoN) has reviewed the draft report and partially concurs with the recommendations. More thorough efforts dedicated to the review of obligations in expired accounts would increase the accuracy and reliability of financial reports. However, problems in departmental financial reports have been recognized as attributable to numerous factors, and DoN must prioritize its approach to pursuing the most effective remedies across-the-board. DoN places a premium on reviewing those accounts available for new obligations, in correcting major systemic problems, and in pursuing improvements in financial management of broad reach. We also do not agree that the difficulty our organizations have had in comprehensively validating unliquidated obligations has precluded the use of funds for other appropriate needs. The availability of resources in expired accounts has been intentionally and progressively limited by the Congress, clearly establishing that the appropriateness of use outweighs the efficiency of use. When appropriate requirements for application of expired balances have arisen, encumbrances for unliquidated obligations have simply not been an impediment.

Our focus on systemic solutions has resulted in significant improvements. For example, outstanding problem disbursement balances in DoN, over $14 billion just a few years ago, have been reduced to less than $400 million in FY 2002. The DoN will continue to explore ways to improve our accounting and reporting systems, in accordance with the priorities that emerge from the Financial Management Modernization Program. In short, we believe that although unliquidated obligation validation requirements are desirable and important, the systemic improvement of our financial information offers the better opportunity for success. Specific comments for each recommendation are enclosed. My action officer is Mr. John Frey, (703) 614-5343, frey.john@hq.navy.mil.

We appreciate the opportunity to comment on the draft report.

Sincerely,

RADM Albert T. Church, III
Director
Office of Budget

GAO DRAFT REPORT - DATED NOVEMBER 8, 2002
GAO CODE 350126/GAO-03-275

"DEFENSE BUDGET: IMPROVED REVIEWS NEEDED TO ENSURE MORE EFFICIENT USE OF OBLIGATED FUNDS"

DEPARTMENT OF DEFENSE COMMENTS
TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Secretary of the Navy to adhere to DoD and Navy unliquidated operating obligation review regulations. (p.12/GAO Draft Report)

DOD RESPONSE: Partially concur. Secretary of Defense direction is not needed to implement the recommendation. DoN has demonstrated that accurate budgetary and financial reports are important by focusing its resources on unliquidated obligations in available appropriations and correcting systemic issues such as problem disbursements. The DoN has made tremendous strides over the past several years in reducing outstanding problem disbursement balances, with an FY 2002 ending year balance of less than $400 million compared with over $14 billion several years ago.

Departmental financial statement accuracy and completeness in general, and unliquidated obligation reviews specifically, are affected by numerous systematic issues; therefore, DoN fund holders are required to prioritize their efforts and have been unable to comply fully with the requirement to review expired appropriations. Since reviewing unliquidated obligations in expired appropriations is required, the Department of the Navy is working to provide automated tools and correct systemic issues which positively impacts the fund holders' ability to perform these reviews.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Secretary of the Navy better apply existing internal control activities to ensure adherence to the DoD and Navy's unliquidated operating obligation review regulations, and to hold fund managers accountable for the accuracy and completeness of their reviews. (p.12/GAO Draft Report)

DOD RESPONSE: Partially concur. Secretary of Defense direction is not needed to implement the recommendation. The Department of the Navy will continue to make the review process itself a continuous part of our management structures and stress the importance of accuracy of monthly and quarterly financial statements.

Appendix III: GAO Contacts and Staff Acknowledgments

GAO Contacts

Sharon Pickup (202) 512-9619
Gary L. Billen (214) 777-5703

Staff Acknowledgments

In addition to the individuals named above, Lori Adams, Linda Garrison, Gregory Kutz, Steve L. Pruitt, Rhonda P. Rose, and R.K. Wild made key contributions to this report.

GAO's Mission

The General Accounting Office, the investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily E-mail alert for newly released products" under the GAO Reports heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, managing director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER