Military Equipment Valuation to Achieve a Clean Audit: Who Cares?

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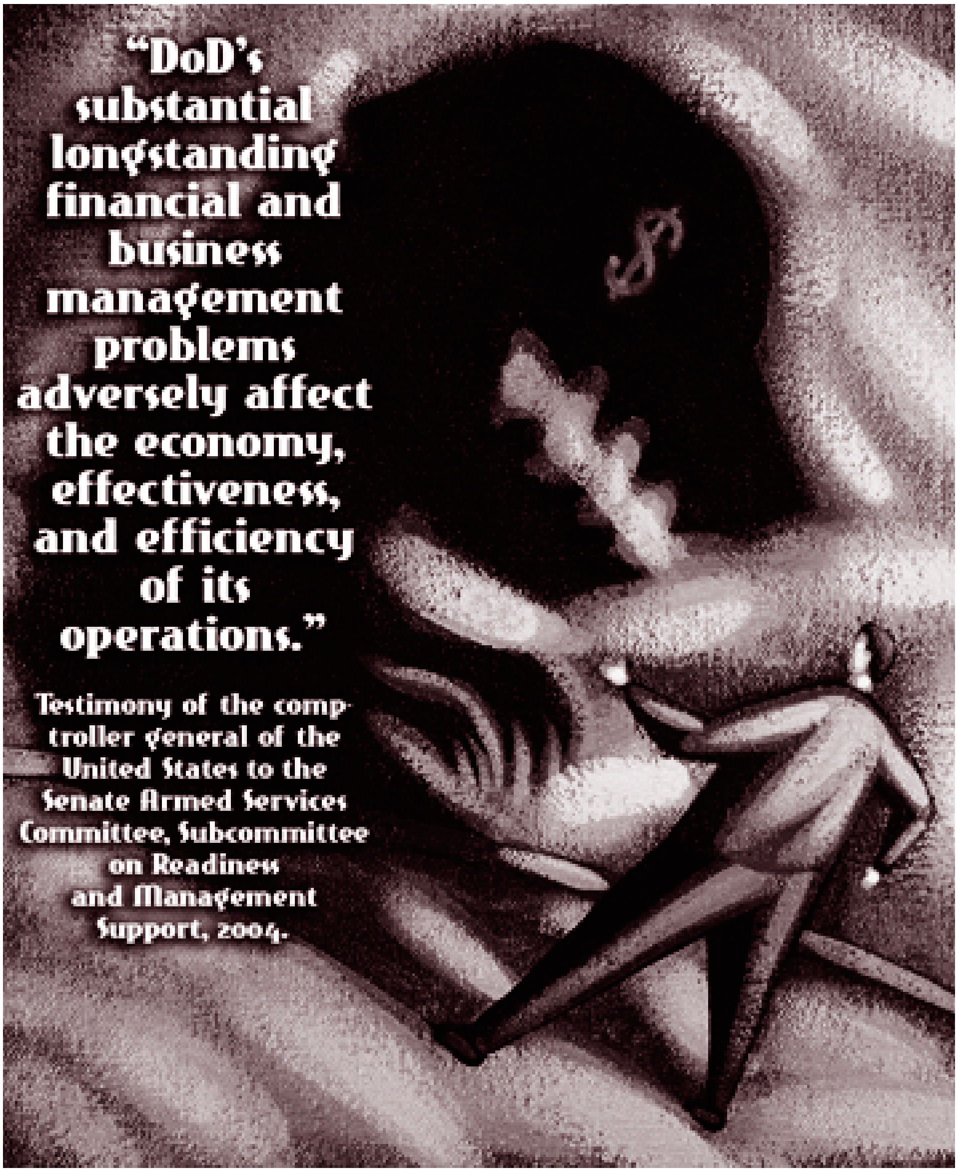

The headline for a Feb. 27, 2004, article on <www.GovExec.com> reads, "Clean Government Audit Remains Elusive." The article opens with this statement: "Financial management problems at the Pentagon continue to prevent the federal government from earning a passing audit."

This is not the kind of publicity that the Department of Defense needs—particularly when the nation is fighting a war. That article and others like it were followed up by testimony from the comptroller general of the United States to the Senate Armed Services Committee, Subcommittee on Readiness and Management Support: "DoD's substantial long-standing financial and business management problems adversely affect the economy, effectiveness, and efficiency of its operations, and have resulted in a lack of adequate transparency and appropriate accountability across all major business areas. As a result, DoD does not have timely, reliable information for management to use in making informed decisions."

Where did the requirement for a clean audit originate? Is a clean audit important? Should program managers (PMs), contracting officers, logisticians, and industry care?

The Requirement for a Clean Audit

In 1990, the Chief Financial Officers (CFO) Act established a requirement that each executive agency of the federal government (DoD and the military departments are classified as executive agencies) will annually prepare and submit to the director of the Office of Management and Budget (OMB) a financial state-

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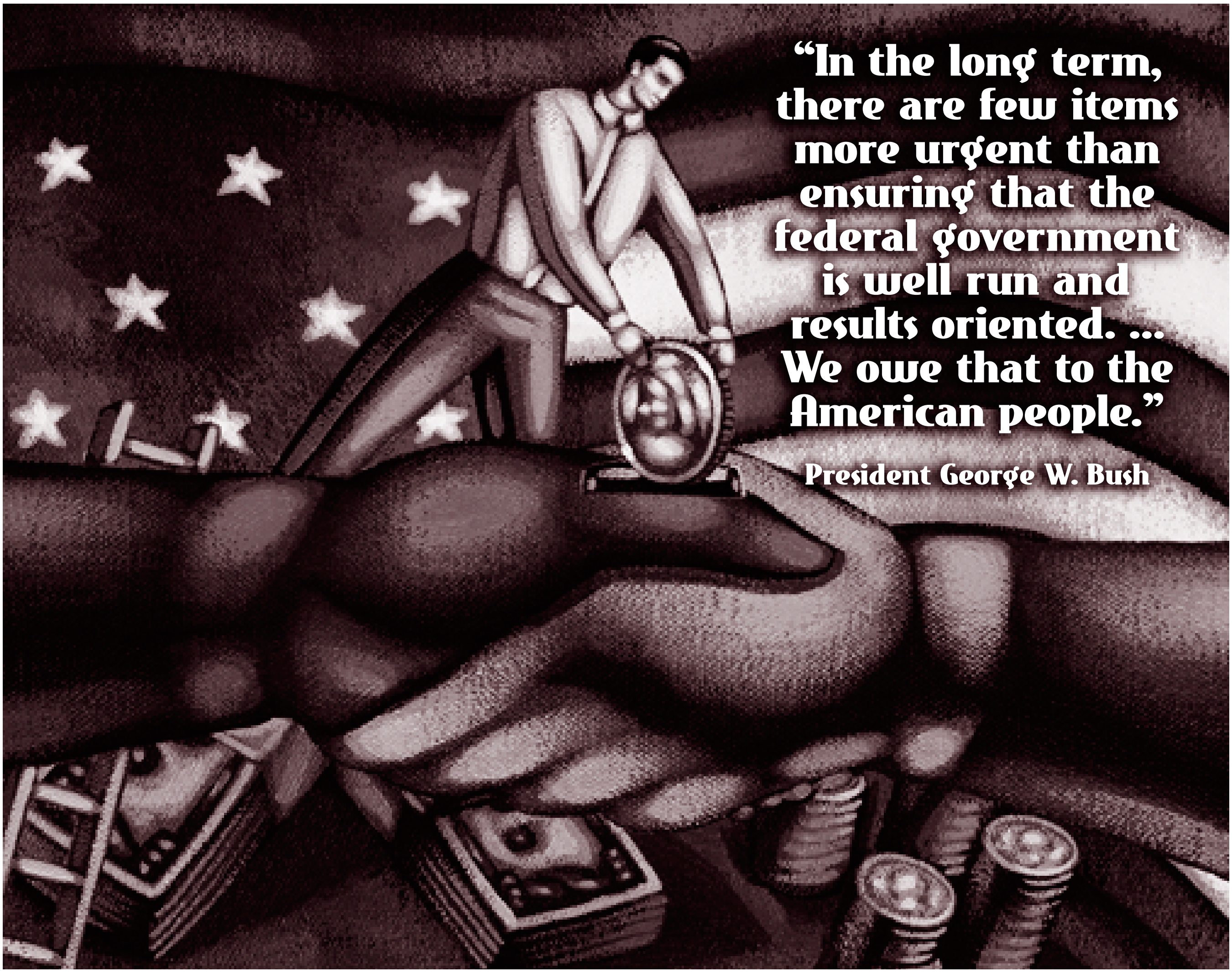


ment for the preceding fiscal year. In addition, the act required that each financial statement be audited by the inspector general of the preparing agency or by an external auditor determined by the inspector general. Further, the comptroller general of the United States can review any inspector general audit and make recommendations to Congress.

In 1996, Congress found that the federal government had made little progress in complying with the intent of the CFO Act over the previous five years. Federal accounting practices still didn't result in accurate financial reporting, nor could financial information generated through current accounting practices be used to determine the full costs of programs and activities to support decision making. To restore public confidence in the federal government, federal agencies needed to make more substantial reforms to their financial management systems. In 1996, Congress passed, and the president signed, the Federal Financial Management Improvement Act. Among other equally important objectives, this act required each executive agency to implement and maintain financial management systems that comply with accounting standards established by the Federal Accounting Standards Advisory Board (FASAB).

When President George W. Bush assumed office, one of his early actions was to develop the President's Management Agenda. In the agenda, President Bush said, "In the long term, there are few items more urgent than ensuring that the federal government is well-run and results-oriented. This Administration is dedicated to ensuring that the resources entrusted to the federal government are well-managed and wisely used. We owe that to the American people." The agenda laid out five initiatives, one of which was improved financial performance. Improving financial performance, according to the agenda, includes obtaining a clean audit opinion because "a clean financial audit is a basic prescription for any well-managed organization."

Getting to Green

In response to the president's direction to obtain a clean audit opinion and thereby "get to green" on the performance scorecard, the secretary of defense immediately established the Financial Management Modernization

Process and System Requirements

Acquisition Planning and Contract Writing

- Identify types of program items to be procured (e.g., deliverable end items, spares, manuals, government-furnished property (GFP), supporting equipment, etc.); and create a valuation template
- Establish a work-in-process (WIP) account
- Identify contracts that contain capitalizable assets
- For identified contracts, write contracts to price each asset type separately

Item Acceptance and Work-in-Process

- Uniquely identify military equipment end items and GFP
- Connect unique identification (UID) to unit acquisition value for end items and GFP at acceptance
- Upon end item delivery, allocate end item costs per contract line item number (CLIN) or sub-contract line item number (SLIN) structure
- Post valuation information to WIP

Military Equipment Valuation

- Upon delivery, perform the calculations required to establish end item full cost (based on valuation template)
- Generate the supporting information (i.e., accounting transactions) to relieve WIP and post to fixed asset accounts

Fixed Asset Accounting

- Account for adjustments to asset value, including major modifications that could change the useful (i.e., depreciable) life and asset disposition changes (disposed, lost, transferred)
- Relate subsequent modifications and upgrades to the original military equipment assets to which they apply
- Calculate depreciation expense

Asset Accountability

- Communicate selected asset disposition changes (disposal, loss, or transfer) to the fixed asset accounting system

Financial Reporting

- Report on DoD component and DoD's consolidated financial statements: WIP, depreciation expense, and net book value of military equipment

Program (FMMP) and directed the under secretary of defense (comptroller) and the assistant secretary of defense (network information infrastructure) to work together to get a clean financial audit opinion as quickly as possible. DoD's comptroller made a commitment to the director of OMB that DoD would begin implementing policy, process, and system changes in fiscal 2003 with the goal of completing implementation in time to achieve a clean audit opinion by the end of fiscal 2006.

After a year and a half, it became clear that the FMMP was misnamed. While the word "financial" captured the attention of all financial personnel throughout DoD, most of the other communities assumed it had little to do with them. In reality, *all* critical business systems in DoD are impacted by this initiative because they interface with financial systems and rely on accurate financial information to conduct business. So in May 2003, the program was renamed the Business Management Modernization Program (BMMP) to better reflect the scope of the initiative, which will impose strict standards on all business systems in DoD and require them to be compliant with DoD's business enterprise architecture (BEA). The BEA will ensure financial compliancy, data accuracy, streamlined processes, and improved decision making across DoD.

Gaining an unqualified audit opinion has been given top priority in BMMP. As President Bush stated, a clean audit opinion is a "good housekeeping seal of approval" that will demonstrate that DoD is a well-run business and is not fraught with "substantial long-standing financial and business management problems [that] adversely affect the economy, effectiveness, and efficiency of its operations." A clean audit opinion will demonstrate that DoD deserves the public's trust and confidence. Ultimately, the BMMP goals go far beyond getting an unqualified audit opinion The real benefits will come from reengineering business processes and integrating systems, which will improve interoperability, information availability, and decision making. Additionally, as we move into a net-centric and data-centric environment, data will travel across the network to be entered only once but used many times. This will eliminate unnecessary duplication, improve data accuracy, and—ultimately—reduce taxpayer costs.

The Balance Sheet

So what is being audited? At the end of the fiscal year, DoD as a whole and the military departments prepare a set of performance and accountability reports. The reports describe performance against strategic plan, strategic objective, annual performance goals, and annual performance results in accordance with the Government Performance and Results Act. The reports also show compliance with legal and regulatory requirements, summarize the status of the President's Management Agenda objectives, and provide financial statements.

One of the principal components of DoD's financial statements is the balance sheet, which provides a summary of DoD's assets and liabilities. The largest asset line item is general property, plant and equipment (GPP&E), which includes the value of real property (land, buildings, structures, utilities, and non-moveable equipment attached to buildings and structures) and personal property (items that are not held for sale or consumed in normal operations including such items as support equipment, plant equipment, vehicles, special test equipment, and special tooling). Prior to 2003, GPP&E did not include military equipment (aircraft, ships, satellites, tanks, for example); however, on May 8, 2003, the FASAB adopted Statement of Federal Financial Accounting Standards 23, which classified all military equipment as personal property. The impact of this change was significant because it required that military equipment be treated the same way as other personal property assets. In other words, military equipment (with a unit cost above the DoD-set capitalization threshold of $100,000) would now have to be valued, depreciated, and reported on DoD's financial statements in the GPP&E line. None of DoD's policies, processes, or systems supports this type of valuation, and as anyone working in acquisition or logistics knows, military equipment is exceptionally complex and very difficult to value.

Transaction-Based Valuation Approach: Towards a Permanent Solution

To satisfy the FASAB requirement to value military equipment, contracts awarded in FY 2007 will require information derived from accounting transactions, invoices, and other authoritative documents that support the actual cost of assets. The costs must be traceable by auditors to the authoritative source documentation. This approach is called the transaction-based valuation approach, and it will enable DoD to track the asset from cradle to grave and to account for the value of the asset.

On Sept. 30, 2006, 100 percent of the delivered DoD military equipment assets will be valued and reported using the baseline valuation approach. As new assets are delivered under contracts awarded on or after Oct. 1, 2006, an increasing number of military equipment asset values will be derived from the valuation methodology contained in the mid-term systems solution and, eventually, the valuation methodology contained in the BMMP solution. Because of the long useful lives of some equipment (ships, for instance), the transition from the baseline to the transaction-based methodology for certain assets may not be complete for as long as 30 years.

Connecting Linked Processes

The transaction-based valuation approach must address three areas: processes, systems, and data. The first area is a set of linked processes. Many of the processes necessary to support military equipment valuation exist today in DoD, although they may differ in operation among the military departments and defense agencies. In order to move to a transaction-based valuation approach, these processes must be linked within the DoD component and, in some cases, reengineered.

The second area is systems that support the processes. In the mid term, beginning in fiscal 2007, a system of systems to support the transaction-based valuation approach will be built using the systems currently in place (with one exception discussed below). In the long term, the system of systems will come out of the BMMP.

The third area is data. The data needed for military equipment valuation are all being collected today, often many times. This data set must be rationalized, integrated, verified, and entered once then used multiple times. The Property and Equipment Policy (P&EP) Office has identified 18 actions to be completed by policy writers, process developers, and system owners in order to implement an auditable, transaction-based valuation methodology. As of June 2004, the P&EP Office, with its business partner KPMG, has completed approximately 10 percent of the effort towards the achievement of these 18 actions. The remainder of this article will address the process reengineering needed to make the systems and data work.

Reengineering the Processes

Six key business processes must be modified and connected to implement this transaction-based approach: acquisition planning and contract writing; receipt, acceptance, and pay and work in process; military equipment valuation; asset accountability; fixed asset accounting; and financial reporting.

As part of the acquisition strategy, the program manager will include a program description at Milestone C for each acquisition program that will acquire end items with a potential full unit cost of over $100,000. The description will identify the end items being acquired (with an indication of those with a unit cost over $100,000), the government-furnished property (GFP) to be provided, and other types of items or services to be bought with program funding (initial spares, manuals, support equipment, special tooling and test equipment, production engineering support, for example). The description will be provided to the accounting specialist who will verify that the program contains end items that should be capitalized as GPP&E (based on the financial management regulations), and determine, based on accounting treatment, which items should be grouped together on one contract line item number in the contract. For example, the end item *manuals and technical data*, which will be capitalized, should be on one CLIN; *spares*, which will be put into inventory, should be on another CLIN.

As the acquisition strategy is translated into contracts, the contracting officer will identify the ones belonging to PMs with capital assets (that is, PMs of programs in which the equipment they are buying meets the requirements for a capital asset). Within the identified contracts, separate types of items must be priced separately using separate CLINs or sub-line item numbers (SLINs). Industry will price each line item on a fixed-price contract and will estimate costs for each item on a cost-type contract. When items are delivered, these prices or updated estimated costs will be provided. Note that there will be no requirement for the contractor to accumulate costs or bill financing payments by separate line item for military equipment valuation purposes.

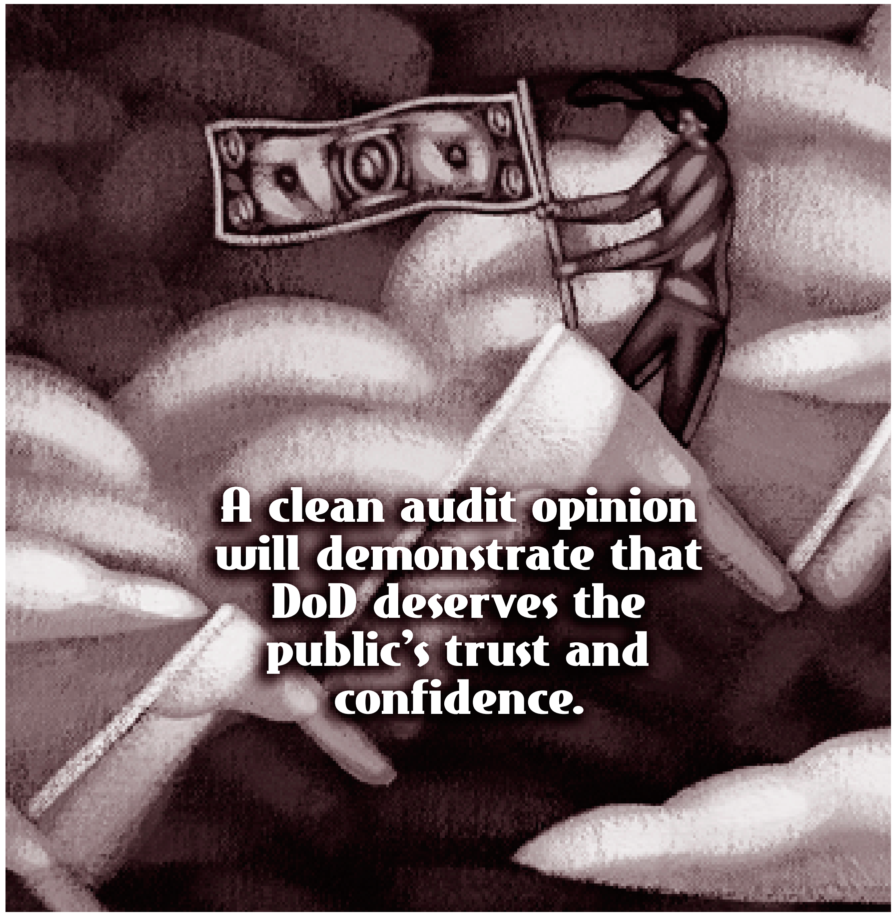
An identified contract will notify the accounting specialist to open a work-in-process (WIP) account and notify the logistician to open a physical property record. The WIP account will capture payments made to contractors during contract performance as well as the value of GFP provided to contractors for use in building the end item. For example, the value of GFP will flow to WIP and the GFP property record will be updated as the GFP is provided to the using contractor. The property record will include GFP used in the end item and will be tied into the unique identification (UID) registry.

When the military equipment is delivered in its final form, the value of the end item and each item type delivered and billed with the end item (spares, support equipment, etc.) will be determined based on and derived from the separately priced item types in the contract. The capital costs of the items delivered will be added to the values of embedded GFP and any allocation of overhead costs (e.g., a share of program office operating costs) to arrive at the full cost of the individual asset. At the same time, the receipt and acceptance system will identify the UID of the end item and the UIDs of the embedded items. This end item information will update the physical property record.

Once the full cost is derived for an individual asset, the WIP account will be relieved. The value of the asset will be transferred to a fixed asset accounting system where the military equipment will be depreciated over its useful life (that is, until it is destroyed or processed for disposal). At the same time, the asset will be transferred to the appropriate Service's physical property accountability system, again to be tracked until the military equipment reaches the end of its operational life. (The fixed asset accounting and physical property accountability systems may be one and the same; for example, the Air Force will use Air Force Equipment Management System (AFEMS) for both processes.)

The amount of WIP, military equipment value, and depreciation will be identified quarterly in the balance sheets of each military department. These amounts will be rolled up to be included in DoD's balance sheets and reported to OMB.

There are a number of process changes that need to be made in order to put a linked set of processes in place. The sidebar on the previous page identifies the process changes that the P&EP Office is pursuing.



So Who Cares?

Now to answer the question posed in the headline: Who cares about military equipment valuation? The simple answer is that everyone in the acquisition, logistics, and accounting communities and in those industries doing business with DoD should! Each community is involved in and affected by military equipment valuation.

Acquisition Community

The PM starts the valuation process by describing his or her program as part of developing the acquisition strategy prior to Milestone C. This description will be shared with the accounting specialist (a new requirement for the PM). The next step is for the contracting officer to identify which of the contracts will need to be "tagged" so that the accounting specialist can follow up. That information will be determinable by tagging all contracts from PMs with capital assets. And finally, for tagged contracts, the contracting officer will write separate CLINs or SLINs for each item.

Accounting Community

Much of the work of valuing military equipment and reporting it on balance sheets is the work of the accounting and finance community and much of this effort will be automated. However, once the PM has described his or her program, the accountants will work with the PMs to ensure that valuation templates are set up to guide how each procured item will be treated from an accounting standpoint. When a tagged contract is received, the accountants will need to open a WIP account so that as payments are made against contracts, the accounting system records them in the appropriate WIP account. Finally, accountants are responsible for assuring that the financial reports are completed and accurate.

Logistics Community

Once the new military equipment valuation processes and systems are in place, the logistics community will have better, more reliable data than in the past and will be relieved of some of the accounting for property values (which will be generated by the accounting system).

Industry

Most military equipment valuation work is done by the government. Nonetheless, contractors will have to price separately each type of asset in the contract bid. For fixed price-type contracts, this will be done as part of the contract negotiation. For cost-type contracts, an estimate will be provided during contract negotiation and updated for the specific asset upon delivery. There will be no requirement for the contractor to accumulate costs or bill financing payments by separate CLIN or SLIN.

Complex—But Well Worth the Effort

The whole process sounds complex—and it is. The good news is that acquisition and logistics professionals will not have to become accountants, and for the accountants, most of the detail work will be done by automated systems. While there is new work to do, that work will build on what the acquisition, logistics, and accounting communities, along with their industry partners, do every day to produce equipment for our warfighters. The end result of all this complexity will be better decisions and more confidence in us from our leadership, Congress, and the American taxpayer.

Editor's note: The author welcomes comments and questions and can be contacted at richard.sylvester@osd.mil.