

Naval Audit Service



Audit Report



Internal Controls over the Department of the Navy's Construction in Progress Account

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N2009-0029
21 May 2009

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7510
N2008-NFA000-0132
21 May 09

MEMORANDUM FOR COMMANDER, NAVAL FACILITIES ENGINEERING
COMMAND

Subj: **INTERNAL CONTROLS OVER THE DEPARTMENT OF THE NAVY'S
CONSTRUCTION IN PROGRESS ACCOUNT (AUDIT REPORT
N2009-0029)**

Ref: (a) NAVAUDSVC memo 7510/N2008-NFA000-0132, dated 28 March 2008
(b) SECNAV Instruction 7510.7F, "Department of the Navy Internal Audit"

1. The report provides results of the subject audit announced in reference (a). Section A of this report provides our finding and recommendations, summarized management responses, and our comments on the responses. Section B provides the status of the recommendations. The full text of management responses is included in the Appendix.
2. Actions taken by Commander, Naval Facilities Engineering Command meet the intent of Recommendation 6, and the recommendation is closed. Actions planned by Commander, Naval Facilities Engineering Command meet the intent of Recommendations 1 through 5. These recommendations are considered open pending completion of the planned corrective actions, and are subject to monitoring in accordance with reference (b). Management should provide a written status report on the recommendations within 30 days after target completion dates. Please provide all correspondence to the Assistant Auditor General for Financial Management and Comptroller Audits, [REDACTED], with a copy to the Director, Policy and Oversight, [REDACTED]. Please submit correspondence in electronic format (Microsoft Word or Adobe Acrobat file), and ensure that it is on letterhead and includes a scanned signature.
3. Any requests for this report under the Freedom of Information Act must be approved by the Auditor General of the Navy as required by reference (b). This audit report is also subject to followup in accordance with reference (b).

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N2009-0029)**

4. We appreciate the cooperation and courtesies extended to our auditors.



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Executive Summary

Overview

The Department of the Navy's (DON's) Construction in Progress (CIP) account is used to accumulate costs of material, labor, and overhead of real property construction projects. Upon project completion, the accumulated costs are transferred to the General Property, Plant, and Equipment (PP&E) asset account as the recorded cost of the real property. General PP&E is the single largest category of assets on the DON financial statement, with CIP being a sub-line item. DON capitalizes General PP&E assets at historical acquisition cost when the acquisition cost equals or exceeds \$100,000. Presently, the Department of Defense (DoD) threshold for reporting real property assets is \$20,000. While the DoD threshold was changed from \$100,000 to \$20,000 in June 2006, DON, with DoD knowledge, has not implemented the \$20,000 threshold pending an evaluation of real property systems, processes, and procedures that will have to be revised in order to implement the lowered threshold.

The Naval Facilities Engineering Command (NAVFAC) is a global military command with a headquarters element and component commands that work together to provide facilities engineering support to DON, Federal agencies, and other DoD clients. NAVFAC is responsible for the CIP account.

We reviewed internal controls over DON's CIP account for construction projects reported during 2nd Quarter 2008. We reviewed written guidance, processes and procedures over invoicing, segregation of duties, and supporting documentation. Internal controls are an integral component of an organization's management providing reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Having accurate, reliable, and timely information is fundamental to the effective administration, management, and financial reporting of assets.

Reason for Audit and Objective

We initiated this audit because DON has, for many years, had significant problems accounting for General PP&E assets, which includes CIP. Although the Naval Audit Service (NAVAUDSVC) has published numerous reports on General PP&E, this is the first NAVAUDSVC audit conducted on CIP and, therefore, there are no earlier audits or recommendations regarding this subject on which to perform followup. A recurring problem in DON's financial reporting has been the lack of accurate tracking, reporting, and transferring of CIP account balances to the Real Property account. DON's Fiscal Year (FY) 2006 and FY 2007 Annual Statement of Assurance on Management Controls noted material weaknesses pertaining to this line item. The recommendations in this audit report will assist DON in improving the accuracy and reliability of CIP financial reporting and real property costs.

Our objective was to verify that internal controls related to the CIP account are in place and functioning to provide reasonable assurance of the accuracy of financial reporting.

Conclusions

We identified significant internal control weaknesses over the CIP account balance reported on the financial statement. The underlying causes include fundamental record-keeping and financial reporting issues, and incomplete or missing source documentation. However, internal controls pertaining to segregation of duties are in place and functioning for the CIP invoice process.

NAVFAC does not maintain a subsidiary ledger to account for and report CIP transaction balances, contrary to DoD Financial Management Regulations. The Federal Financial Management Integrity Act (FFMIA) of 1996 requires agencies to implement and maintain financial management systems that comply substantially with Federal financial management system requirements and accounting standards, and with the U.S. Government Standard General Ledger at the transaction level. Compliance with these requirements is essential in providing readily available audit trails to support amounts reported on the DON's financial statements.

We did not evaluate the impact of DON's noncompliance with the new DoD reporting threshold of \$20,000 on the PP&E account during this audit. However, we plan to address this issue, including DON's plans to bring their reporting into compliance, in an upcoming audit.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act (FMFIA) of 1982, as codified in Title 31, United States Code, requires each Federal agency head to annually certify the effectiveness of the agency's internal and accounting system controls. During this audit, we identified internal control weaknesses in the verification and monitoring of construction project costs. In our opinion, the internal control weaknesses noted in this report may warrant reporting in the Auditor General's annual FMFIA memorandum identifying management control weaknesses to the Secretary of the Navy.

Corrective Actions

To correct the conditions noted in this report, we made recommendations to NAVFAC that, when implemented, will improve internal controls and the accuracy and reliability of CIP financial reporting. We recommend that NAVFAC take actions to improve oversight, documentation, and reconciliation procedures regarding the CIP and Real Property accounts.

NAVFAC concurred with all six recommendations. Planned actions listed in their responses satisfy the intent of the recommendations. Recommendations 1 through 5 are open and Recommendation 6 is considered closed.

Section A:

Finding, Recommendations, and Corrective Actions

Finding: Controls over Project Cost

Synopsis

Internal controls over Department of the Navy's (DON's) Construction in Progress (CIP) account need improvement. The Department of Defense (DoD) Financial Management Regulation (FMR) establishes policies for reporting and relieving CIP. The CIP account is relieved when an asset or an improvement to an asset is placed in service and costs accumulated in the CIP account are transferred to the fixed asset account. Our review determined that: (1) a subsidiary ledger does not exist; (2) supporting documentation was not available to verify total project costs for 31 of 45 CIP projects reviewed; (3) the CIP account was not relieved timely at one location; and (4) reconciliations of the General Property, Plant and Equipment CIP and Real Property accounts were not performed. These conditions existed because NAVFAC CIP personnel were not aware of some financial management regulatory requirements pertaining to construction projects. Therefore, about \$53 million, or 12 percent of the \$452 million of construction project costs reviewed, was not supported by sufficient documentation. We also noted 14 projects that were completed and listed as real property for which the costs had not been removed from the CIP account. This resulted in an overstatement of the DON financial statements for Fiscal Years (FYs) 2004 through 2008. The overstatement in FY 2008 alone was \$151 million.

Discussion of Details

Background

The Naval Facilities Engineering Command (NAVFAC) is assigned design and construction execution responsibilities associated with military construction. NAVFAC is the design agent for all Navy and Marine Corps construction projects, managing projects valued at more than \$2 billion annually. Their mission is to manage the planning, design, construction, contingency engineering, real property, environmental, and public works support for DON around the world. As of 2nd Quarter 2008, DON's CIP account

totaled \$3.1 billion (see Figure 1). NAVFAC uses the Facilities Information System (FIS) for CIP financial reporting.

Figure 1. General Property, Plant, and Equipment (PP&E)

DON's General PP&E account for 2nd Quarter 2008*	
Land and Buildings	14,014
Leasehold Improvements	6
Software	2
General Equipment	5,091
Military Equipment	175,197
Construction in Progress	3,127
Total	\$197,437
*Amounts are represented in millions of dollars.	

CIP begins the life cycle of constructed real property. A CIP account is created in FIS when either of the following triggering events for construction projects occurs: (1) work order and funding authorizations are received; or (2) design and fund authorizations are received. Costs incurred during construction of real property assets are recorded in the CIP account, which is a temporary classification of assets under construction. The costs of new construction and capital improvements are accumulated in a CIP account while the asset is under construction. CIP accounts include all costs incurred to bring the asset to a form and condition suitable for its intended use. All costs to be capitalized for a construction project will be accumulated in the CIP account. The sum of the individual costs in the CIP account will determine the total cost of the asset that is then recorded in the appropriate Property, Plant, and Equipment (PP&E) General Ledger account when the real property assets are placed in service.

A project number is assigned to each approved real property construction project. At least one Real Property Unique Identifier (RPUID) is assigned when the CIP account is created. CIP costs are tracked by both the project number and the RPUID to ensure visibility, traceability, and accountability. A project may include one or more real property asset and corresponding RPUIDs.

The CIP account is relieved when an asset or an improvement to an asset is placed in service. For real property construction projects completed in multiple phases, the cost of each phase is transferred from the CIP account to the real property account at the time the phase is placed in service. Therefore, a facility may have one or more “placed-in-service” dates. Additional costs accumulated in the CIP account after the assets are placed in service will be relieved at the final acceptance of the assets.

Audit Results

Verification of Project Costs

Subsidiary Ledger

A subsidiary ledger is not maintained within FIS to track the construction costs of each project in accordance with the FMR. Data in FIS is not maintained and retrievable at the lowest level of detail to allow a transaction to be traced as required, and the real-time system does not back-up transactions supporting reported amounts. FMR Volume 1, Chapter 3, requires that transactions are to be traceable through a system from initiation through processing to final reports. NAVFAC is not properly maintaining CIP financial information required to support financial reporting. During a March 2008 initial audit meeting, NAVFAC agreed that a subsidiary ledger does not exist, and stated their intent for correction.

We found that the CIP amount submitted to the Assistant Secretary of the Navy, Financial Management and Comptroller, Office of Financial Operations (ASN (FM&C) (FMO)) for financial reporting did not agree with the universe of transactions NAVFAC provided for audit review and analysis – a difference of \$18 million was noted. During our audit, NAVFAC queried FIS and provided a universe of transactions for CIP financial information, such as project number, location, and costs. The data was retrieved after the financial statement report date of 2nd Quarter 2008. Since FIS is a real-time system, all information provided was as of the date retrieved and not as of the financial reporting date, and therefore contained inherent differences. A subsidiary ledger holds the details of an account, supporting the amount stated in the general ledger. Without a subsidiary ledger, CIP detail financial information is not maintained for quarterly reporting and can not be easily traced through the system.

Quarterly, NAVFAC provides CIP data to FMO through the Data Collection Module (DCM) for submission to DON's financial statement. The DCM is a central repository designed to capture financial data from non-financial feeder systems and then provide that information to various Defense Finance and Accounting Service sites via the Defense Departmental Reporting System Audited Financial Statements application.

Supporting Documentation

For all of the 31 CIP projects reviewed, supporting documentation was not available to verify a portion of the total project costs. The FMR requires that financial transactions be supported by source documents. NAVFAC personnel responsible for reviewing and maintaining invoices were aware of the FMR requirements; however, due to a lack of

oversight they did not maintain all of the required source documentation. Lack of supporting documentation prevents verification that CIP financial statement information is correct, and management cannot make with certainty the assertion pertaining to valuation,

We judgmentally selected 45 CIP projects totaling \$452 million, based on location and amount, for project cost verification and requested source documentation from key personnel at five sites. Of the 45 projects reviewed, 31 projects lacked complete source documentation, resulting in an unsupported amount of \$53 million. Six projects managed by two NAVFAC activities and totaling \$136 million had actually been completed and transferred to Real Property. Since the project costs had not been relieved from the CIP account, the projects were included in the universe of CIP projects selected for review. Source documentation files supporting \$22 million of costs associated with the six projects had been archived and could not be readily retrieved during the audit. We included the six projects in our results because, regardless of category (CIP or Real Property), the source documentation requirement is the same. Invoices are the primary source of documentation for CIP costs, and are kept by contract versus project. In most cases, a single project is constructed using multiple contracts; this results in numerous invoices and cumbersome reconciliation. All invoices are received and processed by NAVFAC activities, which are the lowest level of responsibility. The invoices are received by designated personnel at each location via electronic and manual means, and they are maintained at the activity until being archived after transfer of the CIP project to Real Property.

The FMR states that entries to record financial transactions in accounting system general ledger accounts and/or the supporting subsidiary accountable property records and/or systems, must be supported by source documents that reflect all transactions affecting the investment in the General PP&E. All documentation is required to be maintained in a readily available location, during the applicable retention period, to permit the validation of information pertaining to the asset. The information requiring validation is the purchase cost, purchase date, and cost of improvements. For a specified project, and for the purpose of an audit trail of the CIP account, NAVFAC must retain the supporting documentation, which consists primarily of invoices. All applicable documentation must be maintained for a period (currently 10 years) after asset disposal, as required by the U.S. National Archives and Records Administration. We noted differences in FMR document retention rules and the Defense Federal Acquisition Regulation (DFAR) guidance during our review of CIP account relief issues. While the FMR requires document retention for 10 years after property disposal, the DFAR only requires contract specialists to retain contract files in the office for 12 months following project completion. This conflict in regulations is a contributing factor in the difficulty of maintaining the value of real property assets. However, the third standard of field work from the American Institute of Certified Public Accountants (AICPA) Statements on Auditing Standards states: “Sufficient competent evidential matter is to be obtained

through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.” Therefore, if records are discarded too soon, and there is not enough evidential matter to afford a reasonable basis for an audit opinion, the alternative is either a disclaimer or a qualified opinion.

In January 2008, the Accounting and Audit Policy Committee (AAPC) established the General Property, Plant, and Equipment Task Force to assist in developing implementation guidance in Statement of Federal Financial Accounting Standards Chapter 6, “Accounting,” for PP&E. The Task Force is reviewing the PP&E acquisition, disposal, preponderance of use, and records retention policies. The Task Force has completed research work for Government Property, Plant and Equipment (GPP&E) records retention and is in the process of writing a report. Since the audit standard remains regardless of the various interpretations of the laws and regulations, and the AAPC is considering the issue of PP&E document retention, we are making no recommendation at this time regarding regulatory differences pending the outcome of AAPC’s consideration of the issue.

Supervision, Inspection, and Overhead (SIOH)

The SIOH rate charged by NAVFAC to customers cannot be independently verified. The FMR requires that all entries to record financial transactions must be supported. NAVFAC charges the SIOH rate to customers for construction project management services. The SIOH rate is applied to the cost of a construction contract to recover direct and indirect expenses for a project’s construction management services, and includes such things as contract/project administration, cost estimation, and cost management. Funding necessary to support NAVFAC acquisition efforts is either mission funded or reimbursed by the customer, depending on the funding appropriation of the facility requirement. Reimbursement is realized either through a fixed SIOH rate, or through a direct reimbursable. A fully supported SIOH impacts the financial statement assertions and provides assurance that the rate charged is correct.

We requested a written methodology from NAVFAC to determine how the rate was calculated and the current rate for Continental United States (CONUS) and Outside Continental United States (OCONUS) projects. NAVFAC initially stated that the rate is a programmatic, flat rate based on a percentage of construction placement and project location. Also, these rates cover a broad group of projects, which means that for any individual project the actual SIOH cost will not necessarily match the SIOH rate charged. The rate is applied to the individual construction contract award amount, and as the SIOH dollar value is obligated at that time. Of the 45 projects reviewed, 26 projects had SIOH charges totaling \$27 million. Based on the methodology provided, we were unable to reconstruct the SIOH charges associated with these projects. NAVFAC subsequently stated that SIOH is calculated against each individual contract as it is obligated in FIS, rather than on the project’s net obligation value, and that certain contract types such as

A&E, while included in the total obligation value, are exempt from SIOH charges. Finally, NAVFAC personnel assisted with the calculation of SIOH charges for two projects and the auditors were able to verify the SIOH costs charged.

Although SIOH is an acceptable and approved charge, NAVFAC's methodology for calculating fees assessed is difficult to reconstruct and evaluate without assistance. Therefore, we believe NAVFAC should describe all factors and exceptions involved in the calculation of SIOH for verification purposes.

Relieving of CIP

The CIP account was not relieved timely as required by the FMR, which requires CIP to be relieved based on two events – interim/final acceptance or project cancellation. Due to lack of oversight, one NAVFAC location did not remove project costs from FIS at project completion. As a result, the CIP account was overstated by \$151 million for FY 2008.

During project acceptance, CIP is relieved when an asset or an improvement to an asset is placed in service, at which point the cost accumulated to date in the CIP account must be transferred to the appropriate General PP&E account and recorded in the real property inventory. This occurs when projects are about 95 percent completed. When a construction project is cancelled, the cost accumulated in CIP must be expensed.

FIS provides automated notification of projects that have reached the invoice calculation of 95 percent of the current construction working estimate. This is an indicator for the accounting office to relieve the CIP account by transferring the project costs. NAVFAC Atlantic, Pacific, and Southwest sites are responsible for obligating and deobligating funds, as well as relieving the CIP account. We contacted these locations to determine their procedures for relieving CIP. At two sites, this process was carried out monthly. The third site did not relieve CIP as required because the new accounting officer was awaiting instructions from headquarters. By not relieving projects from the CIP account, an overstatement of \$151 million on DON's FY 2008 financial statement occurred. As a result, projects completed in FY 2004 through FY 2008 had not been relieved, resulting in an overstatement. During the audit, the site established procedures to relieve the account timely to prevent future CIP overstatements.

Financial Reporting

Reconciliation of CIP and Real Property Accounts

The amount of completed CIP transferred to the Real Property Account is not being reconciled. The FMR Volume 6a, Chapter 2 requires periodic reconciliation of subsidiary records to financial balances. Reconciliation of CIP account amounts and the Real Property account is very difficult because the financial information is not maintained in a comparable manner in the two systems. As a result, DON's FY 2008 financial statement was overstated by \$151 million.

NAVFAC does not reconcile the originating source data transferred from the CIP account in FIS to the real property costs maintained in the internet Navy Facility Asset Data Store (iNFADS). iNFADS, the system that reports DON's real property assets, is owned and operated by NAVFAC. We asked NAVFAC personnel responsible for financial data maintained in FIS and iNFADS to provide a query that would help associate CIP costs transferred to the real property account. NAVFAC personnel stated that iNFADS maintains financial information by facility type and building number, while FIS maintains financial information by funding, authorization, and project number. Therefore, the reconciliation between the two systems is very difficult, which is the primary reason the accounts are not being reconciled. In addition, NAVFAC has no procedures in place to ensure that CIP and real property accounts are updated simultaneously when an asset is placed in service. When reconciliations are not performed, discrepancies between the systems used to accumulate construction costs and to account for the real property assets may exist, which could result in an overstatement of the corresponding assets on the financial statement.

We found that one site reported \$151 million in both the CIP and real property accounts, which caused the overstatement in the FY 2008 financial report. During the audit, NAVFAC personnel advised that FIS and iNFADS were being upgraded to include data elements that should enable the systems to convey and retrieve information necessary to perform reconciliations. Even with those changes, however, NAVFAC does not have standard operating procedures in place that require reconciliation. Proper procedures and account reconciliation provides assurance that the amounts reported are correct, and can be relied upon to make accurate and timely decisions.

Management at the Functional and Activity Level

Monitoring

Internal controls, such as supervisory review of the \$3.1 billion CIP amount reported through the Data Collection Module (DCM) (as of 2nd Quarter 2008) could be strengthened. The FMR Volume 6A, Chapter 2 states that DoD components are responsible for ensuring the accuracy, completeness, timeliness, and documentary support for all data generated by the components and input into finance and accounting systems. In addition, Government Accountability Office guidance on Standards for Internal Control in the Federal Government states that internal control includes regular management and supervisory activities, comparisons, reconciliations, and other actions people take in performing their management and supervisory duties. One individual compiled and submitted the CIP information for financial reporting to FMO for inclusion in the DCM. The NAVFAC official responsible for the quarterly CIP reporting advised that once the information is retrieved from FIS, the information is manually entered in the DCM without secondary review. When used as a control activity, supervisory reviews can reduce the risk of errors, omissions, and misstatements.

Segregation of Duties

Segregation of duties procedures are in place and executed for CIP, as required by the FMR. At the activity level, the control environment related to the invoicing process is functioning. NAVFAC has written invoicing procedures that provide detailed guidance for performing invoicing, which can reduce the likelihood of mathematical errors, misclassification, and poor recordkeeping. Although all errors, waste, and abuse cannot be prevented, NAVFAC's controls can help reduce the risk of them occurring.

At the five sites visited and responsible for the invoicing of payments, no single person was allowed to perform more than one conflicting function. Segregation of duties exists when one individual is not allowed to perform more than one conflicting function of authorization, recordkeeping, and custodianship. We found that the segregation of duties is maintained for initiating, authorizing, processing, recording, and reviewing CIP transactions at the activity level. At a minimum, three individuals review invoices and supporting documentation for accuracy and conformity with contract provisions prior to authorizing payment. (See Exhibit A for invoicing procedures).

Related Results: Improper Inclusion of Missiles

Missiles were improperly included in the CIP balance for 2nd Quarter 2008. Missiles are categorized as ammunition for financial reporting and should be listed in Note 9 Inventory and Related Property sub-line item Operating Materials and Supplies (OM&S). During the audit, FMO advised that each quarter Defense Finance and Accounting Service (DFAS) provides a CIP amount for inclusion on the financial statement. This amount is referred to as a difference and represents DON's CIP projects built with non-Navy funds. These projects will be transferred to DON upon completion, and therefore, must be included in CIP. FMO advised of a disputed amount that was being researched involving SM-3 missiles.

NAVFAC is unaware of construction projects built with non-Navy funds that will result in DON's preponderance of use. This is because DFAS provides the information to FMO in accordance with the FMR pertaining to the preponderant user rule, which states that the DoD component that reports the General PP&E asset must be able to obtain the benefit and control access to the benefit inherent in the asset. In addition, a military department shall not recognize or report facilities occupied or assets being predominately used by another military department's installation. In June 2008, FMO provided documentation and advised that the CIP account was over-reported by \$32 million and that OM&S was under-reported by the same amount. FMO stated that the misclassification was due to inadvertent error and that a correction was made on DON's financial statement for 3rd Quarter 2008.

Summary and Impact

Opportunities exist to improve the CIP process. Improvement in the CIP process is needed in the verification of project costs, financial reporting, and in monitoring. Without effective internal controls, the reliability of DON's financial reporting of CIP is at risk for misstatement and does not provide reasonable assurance of the accuracy of the data. Internal controls over financial reporting should ensure the safeguarding of assets from waste, loss, unauthorized use, or misappropriation; they should also assure compliance with laws and regulations pertaining to financial reporting. Improving the reliability of CIP financial information will allow NAVFAC and DON to reasonably make the following assertions: existence and occurrence; completeness; rights and obligations; valuation; and presentation and disclosure. Accurate, reliable, and timely CIP data is fundamental to the effective management and financial reporting of construction projects.

Recommendations and Corrective Actions

We recommend that NAVFAC:

Recommendation 1. Establish a subsidiary ledger, which maintains readily available documentation to support all DON financial statement submissions.

NAVFAC response to Recommendation 1. Concur. A formal System Change Request will be forwarded to National Inspection Testing Certification (NITC), by 30 June 2009 to make the project level data available at the general ledger and project levels in COGNOS. This will allow financial statement reporting data to be related back to the general ledger for easier future reconciliations. The new general ledger/project level data is expected to be completed by 30 September 2010 for Financial Statement reporting.

Naval Audit Service comment on response to Recommendation 1. Planned actions meet the intent of the recommendation. NAVFAC's action to make the project level data available at the general ledger and project levels should result in the establishment of a subsidiary ledger. Therefore, we accepted the action as satisfactory. The target date is 30 June 2009.

Recommendation 2. Codify and reissue procedures to maintain documentation to support project costs. Establish internal controls and provide oversight to ensure documentation is maintained.

NAVFAC response to Recommendation 2. Concur. Currently in the Business Management System (BMS) there are policies and procedures that require document retention as related to CIP. The BMS processes will be reviewed and the related CIP document retention areas will be extracted/highlighted and forwarded to the field via email, by 30 September 2009. The long term action will be met under Recommendation 5, the revised automated system process for the DD1354, will require that supporting documentation be associated with the asset electronically within the system.

Naval Audit Service comment on response to Recommendation 2. Planned actions meet the intent of the recommendation. We agree that the Recommendation 5 automated process should essentially have the effect of establishing controls and providing oversight. The automated process will require that source documents (contracts, invoices, etc.) are attached to the

DD1354, to ensure documentation is maintained. This process should result in electronic document retention rather than manual files and eliminate the need for a JV process. The target date is 30 September 2009.

Recommendation 3. Clarify and document procedures describing the method used to calculate SIOH costs.

NAVFAC response to Recommendation 3. Concur. The automated FIS logic has been downloaded and is being used to create a decision tree that defines the areas of the Military Construction (MILCON) project that are SIOH eligible for the standard rate application. This decision tree will be updated as FIS logic is changed in the future, so that there will be a stand alone process to document the SIOH applicable calculation process. The decision tree and related process documentation will be completed by 30 June 2009, as part of the Financial Improvement Plan documentation.

Naval Audit Service comment on response to Recommendation 3.
Planned actions meet the intent of the recommendation.

Recommendation 4. Direct NAVFAC PAC to timely relieve the CIP account by transferring accumulated construction costs to the Real Property fixed assets account, as required by the FMR. Establish internal controls and provide oversight to ensure the CIP account is relieved timely.

NAVFAC response to Recommendation 4. Concur. Guidance will be issued to all NAVFAC commands via email, by 30 June 2009, requiring the timely relief of the CIP account. The Journal Vouchers will be reviewed during future command audit team site visits for documentation support and timeliness. The long term action will be met under Recommendation 5, the revised automated system process for the DD1354.

Naval Audit Service comment on response to Recommendation 4.
Planned actions meet the intent of the recommendation. We agree that the Recommendation 5 automated process should essentially have the effect of establishing controls and providing oversight. Once automated, when projects in FIS reach the invoice calculation of 95 percent, the system will generate the DD1354, which contains the project cost information of real property assets. Once the DD 1354 is signed and dated by the NAVFAC agent and the Real Property Manager, the CIP account should be relieved and the amount should be automatically transferred to the real property system (iNFADS). The planned system changes should result in automatic relief of the CIP account and transfer the costs to the Real Property account. The target date is 30 June 2009.

Recommendation 5. Establish and implement procedures to ensure that CIP and Real Property accounts are reconciled to prevent double reporting. Establish internal controls and provide oversight to ensure the CIP and Real Property accounts are reconciled to prevent double reporting.

NAVFAC response to Recommendation 5. Concur. The new automated process related to the DD1354 development will account for reconciled reporting of the CIP and Real Property accounts for Financial Statement Reporting. This automated process will be fully operational for new MILCON accounts by 30 September 2010.

Naval Audit Service comment on response to Recommendation 5. Planned actions meet the intent of the recommendation. The planned system changes for automated relief of the CIP account should result in management oversight via automated tools for reconciliations and financial information management. In the interim, the NAVFAC Command Audit Team site visits for CIP account relief documentation should provide review and oversight of reporting. The target date is 30 June 2009.

Recommendation 6. Establish and implement written procedures and documented supervisory reviews for all CIP data reported through the DCM. Establish internal controls and provide oversight to ensure documented supervisory reviews are performed.

NAVFAC response to Recommendation 6. Concur. As a part of the documented process, a CIP worksheet is prepared and authorized by NAVFAC HQ FM management (Accounting Supervisor or higher) prior to CIP financial statement figures being reported through the DCM. Documentation will be kept on file to support Financial Reporting. This additional step was added for the second quarter FY 2009 Financial Statement reporting to document supervisory review. Action was completed 7 April 2009. See the attached second quarter FY 2009 report for Financial Statement reporting.

Naval Audit Service comment on response to Recommendation 6. Completed action met the intent of the recommendation and the recommendation is considered closed.

Section B:

Status of Recommendations and Corrective Actions

RECOMMENDATIONS							
Finding ¹	Rec. No.	Page No.	Subject	Status ²	Action Command	Interim Completion date	Target or Actual Completion Date
1	1	13	Establish a subsidiary ledger, which maintains readily available documentation to support all DON financial statement submissions.	O	NAVFAC	6/30/2009	9/30/2010
1	2	13	Codify and reissue procedures to maintain documentation to support project costs. Establish internal controls and provide oversight to ensure documentation is maintained.	O	NAVFAC		9/30/2009
1	3	14	Clarify and document procedures describing the method used to calculate SIOH costs	O	NAVFAC		6/30/2009
1	4	14	Direct NAVFAC PAC to timely relieve the CIP account by transferring accumulated construction costs to the Real Property fixed assets account, as required by the FMR. Establish internal controls and provide oversight to ensure the CIP account is relieved timely.	O	NAVFAC	6/30/2009	9/30/2010
1	5	15	Establish and implement procedures to ensure that CIP and Real Property accounts are reconciled to prevent double reporting. Establish internal controls and provide oversight to ensure the CIP and Real Property accounts are reconciled to prevent double reporting.	O	NAVFAC	6/30/2009	9/30/2010
1	6	15	Establish and implement written procedures and documented supervisory reviews for all CIP data reported through the DCM. Establish internal controls and provide oversight to ensure documented supervisory reviews are performed.	C	NAVFAC		4/7/2009

¹ / + = Indicates repeat finding

² / O = Recommendation is open with agreed-to corrective actions; C = Recommendation is closed with all action completed; U = Recommendation is undecided with resolution efforts in progress

Exhibit A:

Background

The Chief Financial Officers Act of 1990 requires agencies to provide complete, reliable, and timely reporting of real property asset information. Accurate and timely data is crucial to the effective management, planning, forecasting and ultimate achievement of DON missions. Although DON has identified financial reporting as a high priority, the current process to track, value, report, and transfer Construction in Progress (CIP) Account balances does not provide sufficient management oversight to comply with the financial management requirements.

Naval Facilities Engineering Command (NAVFAC) Organization Structure

NAVFAC is a global military command with a Headquarters element and component commands that work together as one team.

NAVFAC Headquarters is an Echelon II Command, with primary responsibility for the following functions: NAVFAC policy and guidance; strategic leadership, planning, and management; process improvement and management; overall financial management, resource allocation and management; and program management.

NAVFAC Atlantic (LANT) and NAVFAC Pacific (PAC) are the Echelon III Commands that have primary responsibility for the following functions: business/support line management and process implementation; product and service delivery, including determination of appropriate reach back capabilities/locations; total force management oversight; execution oversight and support to Echelon IVs; and financial management oversight and support to Facilities Engineering Commands (FECs).

FECs are Echelon IV Component Commands that are subordinate to NAVFAC LANT and NAVFAC PAC. FECs integrate the planning, programming, and execution of facilities engineering and environmental services to Navy installations, and deliver products to services to Supported Commands. Overall, the FECs' role is to oversee construction projects from cradle to grave.

Invoicing Process

NAVFAC's invoicing process consists of reviews and an approval process. Prior to submitting an invoice, the contractor meets with a NAVFAC representative to discuss the amount being invoiced. The contractor generates an invoice for work performed based

on the amount agreed to, and submits the invoice with supporting documentation via email or hard copy in a drop box at the NAVFAC office. If the invoice is submitted via email, the contractor forwards the invoice to the contractor specialist (CS), engineering technician (ET), and project manager (PM). The invoice is stamped with the date and time received. The CS ensures that the invoice is complete and in compliance with the Federal Acquisition Regulation (FAR). The invoice is built in the Facilities Information System and then forwarded to the ET and PM. Both review the invoice and forward it to the CS for review and signature. The CS then forwards the invoice to Defense Finance and Accounting Service (DFAS) for payment. DFAS's responsibilities include processing and paying invoices received.

Exhibit B:

Scope and Methodology

We conducted this performance audit of Internal Controls over the Department of the Navy's (DON's) Construction in Progress (CIP) Account from April 2008 through 25 March 2009. Our audit focused on the CIP amount reported on DON's financial statement for 2nd Quarter 2008.

To address the objective, we reviewed applicable regulations and guidance and discussed operations with key Naval Facilities Engineering Command (NAVFAC) personnel; reviewed procedures for recording and reporting construction project costs; and obtained, reviewed, and analyzed data supporting CIP costs. We determined whether the CIP costs were accurately reported in accordance with applicable laws and regulations, and supported by source documentation. Source documentation reviewed included, but was not limited to: contractor invoices, work requests (WRs), and Military Interdepartmental Purchase Requests (MIPRs).

Since the Facilities Information System (FIS) is a real-time system and does not have a subsidiary ledger, obtaining a universe of transactions was difficult. In addition, FIS maintains construction project costs by funding and authorization, resulting in single projects having multiple listings. Therefore, we judgmentally selected 45 projects for review based on location and amount. We used Microsoft Excel to sort, analyze, and review data obtained from FIS.

Although we relied on computer-generated data in FIS to support audit conclusions, we did not specifically test the system's general or applications controls. However, we established data reliability by reviewing and comparing system data to CIP supporting documentation. We concluded that the data in FIS was reliable to meet audit objectives.

We did not physically verify the existence or completeness of the CIP assets. We also did not validate the labor and overhead values for each CIP project.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Exhibit C:

Pertinent Guidance

Department of Defense (DoD) Financial Management Regulation (FMR) Volume 1, Chapter 3, Key Accounting Requirement Number 7B states that separation of duties and responsibilities must be maintained for initiating, authorizing, processing, recording, and reviewing transactions.

DoD FMR Volume 1, Chapter 3, Key Accounting Requirements Number 8 states that audit trails permit tracing transactions through a system from initiation through processing to final reports. Hence, audit trails allow managers and auditors to ensure transactions are properly accumulated and correctly classified, coded, and recorded in all affected accounts.

DoD FMR Volume 3, Chapter 17, paragraph 170504 states that accounting records at every level shall be designed to permit summarization of financial transactions that produce accurate and timely information from one system of accounts. Data produced shall be in formats required for preparation of prescribed budget and financial reports and for such other day-to-day management data as may be required in executing financial oversight. In addition, records and costs must be designed and maintained so as to facilitate audits of project amounts.

DoD FMR Volume 4, Chapter 6, paragraph 060106 states that entries to record financial transactions in accounting system general ledger accounts and/or the supporting subsidiary accountable property records and/or systems, must be supported by source documents that reflect all transactions affecting the component's investment.

DoD FMR Volume 4, Chapter 6, paragraph 060202 states that the Construction in Progress (CIP) account is relieved when an asset or an improvement to an asset is placed in service, at which point the cost accumulated to date in the CIP account must be transferred to the appropriate General Property, Plant, and Equipment (PP&E) account and recorded in the real property inventory.

DoD FMR Volume 6A, Chapter 2, paragraph 020201 states that DoD Components are responsible for ensuring the accuracy, completeness, timeliness, and documentary support for all data generated and input into finance and accounting systems, or submitted to the Defense Finance and Accounting Service for input and/or recording in the finance and accounting systems and inclusion in financial reports.

Government Accountability Office/Accounting and Information Management Division 00-21.3.1 states that internal controls should generally be designed to assure that ongoing monitoring occurs in the course of normal operations and is ingrained in the agency's operations. Internal controls include regular management and supervisory activities, comparisons, reconciliations, and other actions managers and supervisors take in performing their duties.

Exhibit D:

Activities Visited and/or Contacted

- Marine Corps Base, Quantico, VA
- Naval Facilities Engineering Command, Washington, DC
- Public Works Department, Washington, DC
- Marine Corps Base Kaneohe Bay, HI
- Naval Facilities Engineering Command, Pearl Harbor, HI
- Naval Facilities Engineering Command, Norfolk, VA
- Public Works Department, Norfolk, VA
- Naval Facilities Engineering Command Atlantic, Norfolk, VA
- Naval Facilities Engineering Command Pacific, Pearl Harbor, HI
- Naval Facilities Engineering Command Southwest, San Diego, CA*

* Activity contacted

Exhibit E:**Acronyms**

Acronyms	Names
ASN	Assistant Secretary of the Navy
CIP	Construction in Progress
CONUS	Continental United States
DCM	Data Collection Module
DDRS	Defense Departmental Reporting System Audited Financial Statements
DFAS	Defense Finance and Accounting Service
DoD	Department of Defense
DoD FMR	Department of Defense Financial Management Regulation
DON	Department of the Navy
FFMIA	Federal Financial Management Improvement Act
FMFIA	Federal Managers' Financial Integrity Act
FIS	Facilities Information System
FM&C	Financial Management and Comptroller
FMO	Financial Management Office
FMR	Financial Management Regulation
FOIA	Freedom of Information Act
FOUO	For Official Use Only
iNFADS	Internet Navy Facilities Assets Data Store
NAVAUDSVC	Naval Audit Service
NAVFAC	Naval Facilities Engineering Command
OCONUS	Outside Continental United States
OM&S	Operating Materials and Supplies
POC	Point of Contact
PP&E	Plant, Property, and Equipment
RPUID	Real Property Unique Identifier
SECNAV	Secretary of the Navy
SIOH	Supervision, Inspection, and Overhead

Management Response from Naval Facilities Engineering Command



DEPARTMENT OF THE NAVY
NAVAL FACILITIES ENGINEERING COMMAND
1322 PATTERSON AVENUE, SE SUITE 1000
WASHINGTON NAVY YARD DC 20374-5065

7500
IG2
4 May 09

From: Commander, Naval Facilities Engineering Command
To: Naval Audit Service

Subj: FOLLOW-UP RESPONSE TO NAVAL AUDIT SERVICE DISCUSSION DRAFT
REPORT N2008-0132 INTERNAL CONTROLS OVER DON'S
CONSTRUCTION IN PROGRESS ACCOUNT OF 12 FEB 09.

Encl: (1) Excerpt from Financial Statement for 2nd Qtr FY 2009

1. The follow-up response to the subject discussion draft audit report is as follows:

Recommendation 1. Establish a subsidiary ledger, which maintains readily available documentation to support all DON financial statement submissions.

NAVFAC Response: Concur. A formal System Change Request (SCR) will be forwarded to NITC, by 30 June 2009 to make the project level data available at the general ledger and project levels in COGNOS. This will allow Financial Statement reporting data to be related back to the general ledger for easier future reconciliations. The new general ledger/project level data is expected to be completed by 30 Sept 2010 for Financial Statement reporting.

Recommendation 2. Codify and reissue procedures to maintain documentation to support project costs. Establish internal controls and provide oversight to ensure documentation is maintained.

NAVFAC Response: Concur. Currently in the Business Management System (BMS) there are policies and procedures that require document retention as related to CIP. The BMS processes will be reviewed and the related CIP document retention areas will be extracted/highlighted and forwarded to the field via email, by 30 September 2009. The long term action will be met under recommendation 5, the revised automated system process for the DD1354, will require that supporting documentation be associated with the asset electronically within the system.

Recommendation 3. Clarify and document procedures describing the method used to calculate Supervision, Inspection and Overhead (SIOH) costs.

NAVFAC Response: Concur. The automated FIS logic has been downloaded and is being used to create a decision tree that defines the areas of the MILCON project that are SIOH eligible for the standard rate application. This decision tree will be updated as FIS logic is changed in the future, so that there will be a stand alone process to document the SIOH applicable calculation process. The decision tree and related

process documentation will be completed by 30 June 2009, as part of the Financial Improvement Plan documentation.

Recommendation 4. Direct NAVFAC PAC to timely relieve the CIP account by transferring accumulated construction costs to the Real Property fixed assets account, as required by the FMR. Establish internal controls and provide oversight to ensure the CIP account is relieved timely.

NAVFAC Response: Concur Guidance will be issued to all NAVFAC Commands via email, by June 2009 for the Financial Statement Reporting period. The guidance will require that commands at a minimum relieve the CIP account during month end close by Journal Voucher (JV). The monthly JV will be reviewed during future Audit Team site visits for documentation and timeliness. The long term action will also be met under recommendation 5 and the automated system process for the DD1354.

Recommendation 5. Establish and implement procedures to ensure that CIP and Real Property accounts are reconciled to prevent double reporting. Establish internal controls and provide oversight to ensure the CIP and Real Property accounts are reconciled to prevent double reporting.

NAVFAC Response: Concur. The new automated process related to the DD1354 development will account for reconciled reporting of the CIP and Real Property accounts for Financial Statement Reporting. This automated process will be fully operational for new MILCON accounts by September 2010.

Recommendation 6. Establish and implement written procedures and documented supervisory reviews for all CIP data reported through the DCM. Establish internal controls and provide oversight to ensure documented supervisory reviews are performed.

NAVFAC Response: Concur. As a part of the documented process a CIP worksheet is prepared and authorized by NAVFACHQ FM management (Accounting Supervisor or higher) prior to CIP Financial Statement figures being reported through the DCM. Documentation will be kept on file to support Financial Reporting. This additional step was added for the second quarter FY2009 Financial Statement reporting to document supervisory review. Action was completed 07 April 2009. See the attached second quarter FY 2009 report for Financial Statement reporting.

2. The NAVFAC point of contact is [REDACTED] NAVFAC Command Evaluator at [REDACTED], or email: [REDACTED]

[REDACTED]
Inspector General (Acting)

FOIA (b)(6)

FOIA (b)(6)

APPENDIX: MANAGEMENT RESPONSE FROM THE BUREAU OF MEDICINE AND SURGERY

YEAR	APPN	ACCT		MAR09	SEP08	CHG	
0004	1205	1720.000	CONST	23,046,042.00	29,296,198.42	(6,250,156.42)	
0004	1235	1720.000	CONST	1,826.83	1,826.83	-	
0004	7030	1720.000	CONST	5,706,118.20	5,201,509.17	504,609.03	
0105	1205	1720.000	CONST	25,682,370.96	67,414,659.05	(41,732,288.09)	
0105	1235	1720.000	CONST	75,240.44	75,240.44	-	
0105	7030	1720.000	CONST	26,447,579.17	53,462,955.24	(29,015,376.07)	
0206	0730	1720.000	CONST	59,794,309.13	59,648,651.09	145,658.04	
0206	1205	1720.000	CONST	48,561,329.83	120,456,499.11	(71,895,169.28)	
0206	1235	1720.000	CONST	407,139.93	407,139.93	-	
0307	0730	1720.000	CONST	41,978,810.03	43,687,238.98	(1,708,428.95)	
0307	1205	1720.000	CONST	70,380,662.04	105,789,751.00	(35,409,088.96)	
0307	1235	1720.000	CONST	388,958.18	3,897,047.14	(3,508,088.96)	
0408	0730	1720.000	CONST	9,676,677.44	10,247,221.32	(570,543.88)	
0408	1205	1720.000	CONST	101,275,645.10	140,156,418.50	(38,880,773.40)	
0408	1235	1720.000	CONST	603,856.98	1,653,956.33	(1,050,099.35)	
0506	1206	1720.000	CONST	106,608,836.11	105,608,575.64	260.47	
0507	1207	1720.000	CONST	133,372,330.98	127,750,632.97	5,621,698.01	
0509	0730	1720.000	CONST	960,772.54	3,554,770.17	(7,593,997.63)	
0509	1205	1720.000	CONST	156,429,092.61	224,668,502.51	(68,239,409.90)	
0509	1235	1720.000	CONST	1,457,380.89	1,045,662.71	411,718.18	
0610	0730	1720.000	CONST	83,605,978.19	65,049,435.77	(1,443,457.58)	
0610	1205	1720.000	CONST	378,932,358.98	659,817,946.00	(280,885,587.02)	
0610	1235	1720.000	CONST	39,377,855.66	37,509,825.79	1,868,029.87	
0708	1206	1720.000	CONST	-	-	-	
0711	0730	1720.000	CONST	82,445,412.81	44,615,667.53	37,829,745.28	
0711	1205	1720.000	CONST	465,435,693.43	574,942,676.14	(109,506,982.71)	
0711	1235	1720.000	CONST	1,323,356.10	18,162,275.95	(16,838,919.85)	
0809	1206	1720.000	CONST	-	-	-	
0812	0730	1720.000	CONST	7,722,307.15	926,312.12	6,795,995.03	
0812	1205	1720.000	CONST	391,123,259.29	125,518,122.69	265,605,136.60	
0812	1235	1720.000	CONST	13,529,919.71	2,806,791.74	10,723,127.97	
0913	0730	1720.000	CONST	-	-	-	
0913	1205	1720.000	CONST	44,758,331.22	-	44,758,331.22	
0913	1206	1720.000	CONST	-	-	-	
0913	1235	1720.000	CONST	94,147.67	-	94,147.67	
9903	1205	1720.000	CONST	-	15,808,157.86	(15,808,157.86)	
9903	1235	1720.000	CONST	-	-	-	
9903	7030	1720.000	CONST	-	5,269,331.98	(5,269,331.98)	
XXXX	1205	1720.000	CONST	-	-	-	
				2,321,203,599.60	2,682,451,000.12	(361,247,400.52)	
						(21,077,489.84)	
CIP PERIOD		BEGINNING BALANCE	ADDITIONAL COSTS	TRANSFER OUT COMPLETED	PRIOR PERIOD ADJUSTMENT	ENDING BALANCE	% CHG
Q2		2,682,451,000	(66,966,172)	(487,067,419)		2,321,203,689	-13.5%
Q1		2,682,451,000	448,254,942	(487,067,419)	(9,575,817)	2,643,638,524	-1.8%

Reviewed by _____

FOIA (b)(6)

APPENDIX: MANAGEMENT RESPONSE FROM THE BUREAU OF MEDICINE AND SURGERY

YEAR	APPN	ACCT	MAR09	SEP08	CHG
0004	1205	3230.000	967,575,253.04	961,448,587.54	6,126,665.50
0004	1235	3230.000	26,976,045.90	26,976,045.90	-
0004	7030	3230.000	330,475,981.72	329,980,905.17	495,076.55
0105	1205	3230.000	878,268,057.50	836,444,375.62	41,823,681.88
0105	1235	3230.000	63,354,206.58	63,354,206.58	-
0105	7030	3230.000	358,871,529.56	329,855,780.49	29,015,749.07
0205	0730	3230.000	218,761,626.04	212,216,958.87	6,544,667.17
0205	1205	3230.000	1,067,083,874.26	995,060,796.07	72,023,078.19
0205	1235	3230.000	52,299,462.29	52,299,462.29	-
0307	0730	3230.000	148,915,809.57	147,135,808.77	1,780,000.80
0307	1205	3230.000	1,242,222,848.09	1,206,233,376.51	35,989,471.58
0307	1235	3230.000	74,520,906.62	70,556,256.53	3,964,650.09
0409	0730	3230.000	150,149,138.74	147,854,040.96	2,295,097.78
0409	1205	3230.000	1,039,170,965.78	995,899,414.83	43,271,550.95
0409	1235	3230.000	39,487,705.12	38,395,150.27	1,092,554.85
0505	1206	3230.000	26,108,271.28	26,108,271.28	-
0507	1207	3230.000	-	-	-
0509	0730	3230.000	8,630,062.82	164,017.78	8,466,045.04
0509	1205	3230.000	845,893,457.99	751,632,717.34	94,260,740.65
0509	1235	3230.000	35,703,716.06	35,618,540.75	85,175.31
0610	0730	3230.000	20,182,732.40	3,408,557.24	16,773,775.16
0610	1205	3230.000	973,471,574.67	518,734,345.17	454,737,229.50
0610	1235	3230.000	39,507,343.47	20,019,820.73	19,487,522.74
0703	1206	3230.000	-	-	-
0711	0730	3230.000	20,598,112.24	20,560,247.90	37,864.34
0711	1205	3230.000	449,251,118.54	143,158,267.15	306,092,851.39
0711	1235	3230.000	33,813,913.83	12,839,139.12	20,974,774.71
0809	1206	3230.000	-	-	-
0812	0730	3230.000	-	-	-
0812	1205	3230.000	7,619,471.05	773,033.75	6,846,437.30
0812	1235	3230.000	-	-	-
0913	0730	3230.000	-	-	-
0913	1205	3230.000	54,307.16	-	54,307.16
0913	1206	3230.000	-	-	-
0913	1235	3230.000	-	-	-
9903	1205	3230.000	-	583,978,855.32	(583,978,855.32)
9903	1235	3230.000	-	27,986,690.14	(27,986,690.14)
9903	7030	3230.000	-	265,092,194.12	(265,092,194.12)
XXX%	1205	3230.000	1,418,191.05	1,418,191.05	-
			9,120,385,683.37	8,825,204,455.24	295,181,228.13
				877,057,739.58	

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