Audit Report

PENTAGON RESERVATION MAINTENANCE
REVOLVING FUND

Report No. D-2001-153 July 2, 2001

Office of the Inspector General
Department of Defense

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Acronyms

CIP	Construction in Progress
FMR	Financial Management Regulation
PRMRF	Pentagon Reservation Maintenance Revolving Fund
WHS	Washington Headquarters Services

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July 2, 2001

MEMORANDUM FOR DIRECTOR, WASHINGTON HEADQUARTERS SERVICES
PROGRAM MANAGER, PENTAGON RENOVATION PROGRAM

SUBJECT: Audit Report on the Pentagon Reservation Maintenance Revolving Fund (Report No. D-2001-153)

We are providing this audit report for information and use. We performed the audit to support the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We considered management comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. David F. Vincent at (703) 604-9109 (DSN 664-9109) (dvincent@dodig.osd.mil) or Ms. Barbara A. Sauls at (703) 604-9129 (DSN 664-9129) (bsauls@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. D-2001-153 **July 2, 2001**
(Project No. D2001FH-0045)

Pentagon Reservation Maintenance Revolving Fund

Executive Summary

Introduction. We performed the audit to support the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. DoD real property, valued at $100.9 billion in FY 2000, represented 90 percent of the $112.5 billion investment made by DoD in property, plant, and equipment. Real property also represented 16 percent of the total assets reported on the FY 2000 DoD Agency-Wide Consolidated Balance Sheet. Consequently, the DoD must accurately report property, plant, and equipment in order for the Government to achieve a favorable opinion on the consolidated financial statements of both the DoD and the Federal Government. The DoD incorporates the Pentagon Reservation Maintenance Revolving Fund into the Other Defense Organizations in its financial statements. The Washington Headquarters Services manages this fund, which has financed at least $878.7 million of construction. Congress has specified that the total cost for the planning, design, construction and installation of equipment for the renovation of the Pentagon Reservation could not exceed $1.2 billion. However, the Office of the Deputy Secretary of Defense tasked the Pentagon Renovation Program with ancillary projects outside of its original scope of work. This requires the program to distinguish between renovation projects that fall within the $1.2 billion spending limit set by Congress and Nonrenovation projects that fall outside the congressional limitation.

Objectives. Our objective was to determine whether the Pentagon Reservation Maintenance Revolving Fund had properly recorded and reported the costs associated with recent construction projects at the Pentagon Reservation. The Pentagon Reservation includes the Pentagon, the Navy Annex, and other buildings. We also reviewed procedures and documentation used for the cost projection reported to Congress and the management controls associated with maintaining financial databases.

Results. For financial statement purposes, the Washington Headquarters Services did not accurately record or report the construction costs resulting from the renovation of the Pentagon Reservation. At least $50.1 million of overhead costs associated with the renovation were not included in the construction in progress account. Completed projects dating back to 1992 were not transferred from construction in progress to the real property accounts, resulting in a misstatement of at least $210.3 million. Other errors in the real property accounts included not removing $12.1 million for the old heating and refrigeration plant that was demolished and using incorrect methods to

calculate depreciation. As a result, the FY 2000 Pentagon Reservation Maintenance Revolving Fund balance was misstated by at least $289.6 million (finding A).

The annual "Status Report to Congress on the Renovation of the Pentagon" did meet the legislative reporting requirements. However, the FY 2000 Status Report could have more clearly stated that the program management office reduced the scope of the renovation by roughly $564.8 million. The FY 2000 Status Report to Congress only briefly mentions the challenging financial aspects of the major construction and renovation work conducted on the Pentagon Reservation. A more complete reporting of the projects and costs in the Status Report to Congress should help readers appreciate the difficulties facing the program management office under the current spending limit (finding B). See Appendix A for details on the management control program as it relates to controls over the recording and reporting of construction costs.

Summary of Recommendations. We recommend that the Director, Washington Headquarters Services develop policies and procedures to accumulate overhead costs. We recommend that the Director establish policies and procedures to transfer completed projects and their associated overhead costs to the real property accounts. We also recommend that the Director revise existing depreciation policies to bring them into conformance with the Financial Management Regulation.

We recommend that the Program Manager, Pentagon Renovation Program provide a more complete picture of all the costs associated with the renovation and major construction efforts in future reports, regardless of classification in the Status Report to Congress. We also recommend that the Program Manager provide more detail about the difficult and complex changes needed to keep the program under the congressional spending limit.

Management Comments. The Director, Washington Headquarters Services and the Program Manager, Pentagon Renovation Program concurred with the recommendations and initiated plans for corrective actions. See the Findings section of the report for a discussion of the management comments and the Management Comment section for the complete text.

Audit Response. We consider the Director, Washington Headquarters Services and the Program Manager, Pentagon Renovation Program comments to be responsive to the recommendations. Based on management comments, we modified our report where appropriate. See the Finding section for the complete text of the audit response.

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Background

This audit was performed to support the requirements of Public Law 101-576, the "Chief Financial Officer's Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. DoD real property, valued at $100.9 billion in FY 2000, represented 90 percent of the DoD's $112.5 billion investment in property, plant, and equipment. Real property also represented 16 percent of the total assets reported on the FY 2000 DoD Agency-Wide Consolidated Balance Sheet. Consequently, the DoD must accurately report property, plant, and equipment in order for the Government to achieve a favorable opinion on the consolidated financial statements of both the DoD and the Federal Government.

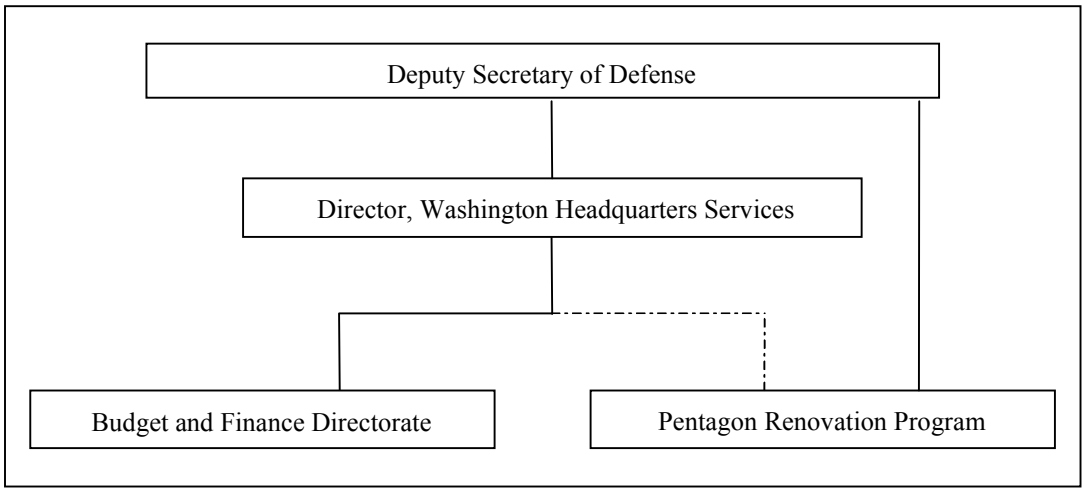
The DoD incorporated the Pentagon Reservation Maintenance Revolving Fund (PRMRF) into the Other Defense Organizations in the FY 2001 DoD Agency-Wide Financial Statements. Congress established the PRMRF by transferring responsibility for the operation, maintenance, and management of the Pentagon Reservation to the Secretary of Defense. The Pentagon Reservation consists of the Pentagon Office Building, Federal Building Number 2, the Pentagon heating and sewage treatment plants, and other related facilities. The PRMRF was designed to operate on a break-even basis over the long term. Funds were generated for the PRMRF through user charges for building space and services.

The Pentagon Office Building has never undergone a major renovation. As a result, the DoD had to renovate the building in order to meet current health, fire, and life safety codes. The DoD also had to provide reliable electrical, air conditioning, and ventilating services. The FY 2000 DoD Appropriation Act required the Secretary of Defense to certify that the total cost for the planning, design, construction and installation of equipment for renovating the Pentagon Reservation would not exceed $1.2 billion. The fund has already financed at least $878.7 million of construction, though not all of which applied against the congressional spending limit. According to current estimates, the program should be completed by FY 2014.

Office of the Deputy Secretary of Defense tasked the Pentagon Renovation Program with ancillary projects outside of its original scope of work. This requires the program management office to distinguish between renovation projects that fall within the $1.2 billion spending limitation set by Congress and nonrenovation projects that fall outside the congressional limitation. Furthermore, since the Pentagon was declared a National Historic Landmark in 1992, its special status placed significant restrictions on external renovation activities and presented several challenges to the renovation team.

The Secretary of Defense was given the authority to manage the Pentagon Reservation. DoD Directive 5110.4, "Washington Headquarters Services," May 10, 1999, delegates the Washington Headquarters Services (WHS) to execute the Secretary of Defense's authorities over the Pentagon Reservation. The WHS further split the responsibilities for the fund's activities among its various divisions. The Budget and Finance Directorate processed most of the accounting transactions and retained the supporting documentation for the values reported on the financial statements. The Pentagon Renovation Program is responsible for renovating the Pentagon. This program management office is

responsible for the development and control of budgets, work schedules, acquisition strategy, and other tasks involved with the renovation. The U.S. Army Corps of Engineers had served as the design and construction manager for the renovation, but the Corps voluntarily withdrew from the program in FY 2000. The following figure shows the Pentagon Renovation reporting channel.



Reporting Channel for the Pentagon Renovation

Objectives

The overall objective was to determine whether the PRMRF had properly recorded and reported the costs associated with recent construction projects at the Pentagon Reservation. Specifically, we reviewed the procedures for collecting financial information, inspected supporting documentation for account balances. We determined whether construction costs were properly included in the DoD Agency-Wide Financial Statements. We also reviewed procedures and documentation used for the cost projection reported to Congress and the management controls associated with maintaining financial databases. See Appendix A for a discussion of the audit scope and methodology and the review of the management control program. Our review of the budgetary guidance provided in the Financial Management Regulation (FMR) is located in Appendix B.

A. Construction in Progress and Other Real Property Accounts

For financial statement purposes, the WHS did not accurately record or report the construction costs resulting from the renovation of the Pentagon Reservation. The costs were not recorded or reported properly because of noncompliance with applicable regulations and weak internal controls. Consequently, the WHS misstated its construction in progress (CIP) and property accounts.

- Overhead costs totaling at least $50.1 million were not included in the CIP account.

- Twenty-three completed construction and capital improvement projects dating back to 1992 and totaling at least $210.3 million were not transferred from CIP to the real property account. The WHS transferred one completed project improperly that resulted in a misstatement of at least $16.9 million.

- A $12.1 million asset demolished in 1998 was not removed from the financial records.

- Depreciation costs for capitalized assets were incorrectly calculated and therefore misstated by at least $213,854.

Consequently, the FY 2000 balance for the PRMRF was misstated by at least $289.6 million. Unless adjustments are made to correct the misstated accounts and internal controls are improved, PRMRF financial information for FY 2001 and beyond will continue to be misstated and unreliable.

Construction in Progress and Real Property Laws and Regulation

DoD Regulation 7000.14-R, "DoD Financial Management Regulation (FMR)," volume 4, chapter 6, "Accounting Policy and Procedures – Property, Plant, and Equipment," dated August 2000, provides accounting guidance for property, plant, and equipment. The Regulation emphasizes the need for supporting documentation to:

- support financial records entered into accounting systems and supporting property records,

- record all acquisitions of property the date custody is taken,

- identify and classify property that was capitalized and recorded in the property accountability system, and
- provide information to identify and account for capitalized improvements to property, plant, and equipment.

The FMR also states that the cost to construct an asset should be recorded as CIP until the asset is completed and available for use. The CIP account should include direct labor, direct material, and overhead. Overhead may include the costs of supervision and other indirect labor, supplies and materials, transportation, and depreciation. Upon completion of the construction project, the accumulated costs should be transferred to the proper property, plant, and equipment account if the cost exceeds the DoD capitalization threshold of $100,000.

Policies and Procedures for Processing CIP Costs

Although the PRMRF had financed at least $878.7 million of construction, the WHS did not have policies and procedures in place to accurately accumulate overhead costs for construction projects. The WHS did not have procedures for transferring completed projects out of CIP or assigning CIP costs to the appropriate accounts. Those problems resulted in a misstatement of at least $277.3 million in the CIP and other property accounts.

Overhead Calculation. The WHS Budget and Finance Division did not include payroll, travel, and training costs from the program management office in the CIP account. Those costs may be categorized as indirect labor and are therefore a component of overhead. The Pentagon Renovation Program, Budget and Finance Directorate, and Real Estate and Facilities Directorate incurred costs that should have been accumulated and charged to CIP. Based on standard Army Corps of Engineers overhead rates for construction projects, the CIP account may have been understated by at least $50.1 million.

Completed Projects. According to the U.S. Army Corps of Engineers - Baltimore District records, the Corps of Engineers completed 24 major projects for the Pentagon Renovation Program. The earliest project was completed in 1992. Statement of Federal Financial Accounting Standard No. 6 states that a constructed building shall be recorded as construction work in process until it is placed in service. Then, the balance should be transferred to general property, plant, and equipment.

The Corps of Engineers considered those projects substantially complete and issued DD Forms 1354, "Transfer and Acceptance of Military Real Property," to the WHS. In accordance with the FMR, DoD components may use the DD Form 1354 to support the acquisition of completed property transferred into property accounts. The WHS Budget and Finance Directorate never received those forms. Consequently, the WHS did not transfer at least 23 completed projects out of CIP resulting in a misstatement in both the CIP and other real

property accounts of at least $210.3 million. By not transferring the completed projects, the WHS also had an undeterminable understatement in the depreciation accounts.

Transferred Projects. After completing the heating and refrigeration plant, the WHS transferred $79.9 million out of the CIP account. The WHS sent direct citation funds to the Corps of Engineers to finance this project and used reimbursable funds for all the other projects. This allowed the WHS to simply query their ledgers to identify the direct citation funds associated with the building. Then, the WHS transferred that amount into the building account.

According to the DD Form 1354 prepared by the Corps of Engineers for this project, the new heating and refrigeration plant had a total cost of $96.8 million. This amount differed materially from the $79.9 million that the WHS had posted in its ledgers. Presumably, the Corps of Engineer allocated additional costs that were financed by the reimbursable funding documents that they received from the WHS, but the WHS may have accidentally expensed some of the initial planning and design cost. The WHS Budget and Finance Directorate stressed that if they had received the DD Form 1354 from the Corps of Engineers, they would have properly recorded this asset in the accounting system.

The WHS transferred the cost of the new heating and refrigeration plant and its equipment to the building account, and they assigned it a 20-year depreciable life. The FMR states that new buildings have a 40-year life and power generators have a 20-year life. The WHS treated the new plant and its equipment as one asset, a power generator, because they did not know how to allocate the construction costs between the generator and the building. If the accounting division had received the DD Form 1354 that details the cost of the plant and its equipment, the WHS may have transferred the CIP costs into the appropriate real property accounts.

For the completed plant, the WHS understated the property accounts by at least $16.9 million. They also assigned the wrong depreciation life, resulting in an undeterminable understatement in the depreciation accounts.

Policies and Procedures for Real Property Accounts

The WHS did not have written policies and procedures in place to accurately remove deleted assets from the property accounts or to depreciate buildings reported on the financial statements. Those problems created a misstatement of at least $12.3 million in various real property accounts.

Removing Deleted Assets. After the construction of the new heating and refrigeration plant in 1998, the WHS demolished the old heating and refrigeration plant. While the WHS fully depreciated the old plant, the WHS did not remove this demolished asset from their property records. As a result, this cost continued to reside in their financial statements. The WHS did not remove this asset from their records because they were not aware that they should remove demolished assets. As a result of this oversight, the buildings and accumulated depreciation accounts were overstated by at least $12.1 million.

Depreciation Policy. The WHS improperly calculated depreciation in its real property accounts because the accounting system used an unapproved method. According to guidance issued by the DoD Comptroller, DoD components should have used a monthly depreciation method for assets acquired before October 1998. According to this method, assets are depreciated starting on the first day of the month following their acquisition or the date the asset is installed and ready for use. The WHS used a daily depreciation method. By using this method, the accounting system started depreciating assets on the day that they were acquired.

The accounting system also depreciated certain capital improvements throughout FY 2000. However, since those assets were in the final year of their useful life, the accounting system should have only depreciated those assets for a portion of the year. This resulted in a $213,854 misstatement in the deprecation accounts. At the end of FY 2000 those assets were fully depreciated, and therefore this will have no future effect on accumulated depreciation.

For all new assets, the FMR requires DoD agencies to calculate depreciation either on a Mid-Year or Month Available for Service Method. Under the Month Available for Service Method, agencies start calculating depreciation expense the month that the asset is "available for use." Under the Mid-Year Convention Method, agencies calculate and expense 6 months of depreciation in the first and last year of an asset's useful life, regardless of the actual month the asset was placed or removed from service. The FMR does not specifically permit the daily depreciation method used by the WHS.

Conclusion

Because of poor communication among the WHS directorates receiving the completed DD Forms 1354 and the Budget and Finance Directorate, the WHS did not properly transfer completed projects out of the CIP account. Improved coordination among the WHS directorates involved with the construction projects on the Pentagon Reservation would result in accurate overhead calculations and timely transfer of completed projects out of the CIP account. In addition, several errors in the real property accounts were caused by not following the guidance provided in the FMR. Many of those errors could have been avoided by developing and following written procedures for processing CIP and other real property information.

Management Comments on the Finding and Audit Response

Management Comments. The Director, Washington Headquarters Services noted that the old heating and refrigeration plant had no net effect on the financial statements because it was fully depreciated. The Director also stated that when the DoD revised its deprecation policies, the DoD directed its components to continue depreciating their assets using the prior guidance rather than adjusting them to the new policies.

Audit Response. Although the old heating and cooling plant was fully depreciated, the individual account balances will continue to be misstated until the demolished asset is removed from the financial statements.

The Washington Headquarters Service correctly noted that the assets acquired before 1998 should be depreciated according to the older guidance. Nevertheless, based on additional information obtained, the Washington Headquarters Services Allotment Accounting System used a depreciation method that did not conform to the older depreciation guidance.

Recommendations and Management Comments

A. We recommend that the Director, Washington Headquarters Services:

1. Develop policies and procedures to accumulate and allocate overhead costs associated with the capital improvement projects to specific capital improvement projects in proportionate amounts.

Management Comments. The Director concurred and agreed to develop procedures for applying overhead to all construction in progress projects.

2. Establish policies and procedures to properly transfer completed construction projects from the construction in progress account to the real property accounts. The procedures should also include a process for creating and retaining appropriate supporting documentation for both additions and deletions to the real property account.

Management Comments. The Director concurred and agreed to develop a property transfer form similar to the DD Form 1354, Transfer and Acceptance of Military Real Property. The form will identify the appropriate construction costs to be used in transferring completed projects from the construction in progress account to the real property accounts.

3. Revise existing depreciation policies to bring them in conformity with volume 4, chapter 6 of the Financial Management Regulation, "Accounting Policy and Procedures – Property, Plant, and Equipment."

Management Comments. The Director concurred and agreed to reprogram the Washington Headquarters Services Allotment Accounting System so that it uses the proper depreciation policies.

B. The Status Report to Congress and Projected Renovation Costs

The annual Status Report to Congress did meet the legislative intent of section 2674, title 10, United States Code (10 U.S.C. 2674). However, the FY 2000 "Status Report to Congress on the Renovation of the Pentagon," dated March 1, 2000, only gives brief mention to the financial aspects of individual Renovation projects. The report also primarily focuses on the cost of renovating the Pentagon Office Building and not the cost of all the major construction work performed on the Pentagon Reservation. The WHS limited their discussion of the Nonrenovation projects because according to 10 U.S.C. 2674, the Status Report to Congress does not have to include the cost of Nonrenovation projects. The Nonrenovation efforts may cost as much as $1.7 billion from FY 2000 to FY 2015. By including additional details about the Nonrenovation efforts and the specific Renovation projects, future Status Reports to Congress could present a more complete picture of the difficult aspects of the renovation and major construction efforts conducted on the Pentagon Reservation.

Sufficiency of the Information Provided in the FY 2000 Status Report to Congress

According to 10 U.S.C. 2674, the Secretary of Defense must submit a report to Congress on a yearly basis regarding the status of the renovation of the Pentagon Reservation. The report should include a plan for the renovation work that will be conducted during that fiscal year. Since the creation of the PRMRF, numerous construction projects have been completed on the Pentagon Reservation. As the renovation efforts progressed, the construction management team encountered numerous unexpected complications such as diesel fuel contamination and unmapped electrical wiring. Other issues further complicated the program management office's ability to complete major construction efforts on the Pentagon Reservation. For example, the work performed by the Pentagon Renovation Program also addressed many other construction projects that the WHS stated did not fall under the congressional spending limit. For example, the new heating and refrigeration plant and many security driven additions integrated into the building do not fall under the spending limit. The program management office also agreed to serve as the construction agent for various other ancillary projects on the Pentagon Reservation, such as the Remote Delivery Facility and the Heliport Fire Station and Control Tower.

The Pentagon Renovation Program has categorized the major construction projects as "Renovation Ceiling" or "Nonrenovation." The Renovation Ceiling category includes those items that apply to the congressional spending limit. Nonrenovation projects include the major construction efforts that do not apply

to the congressional spending limit. The Remote Delivery Facility and the Heliport Firestation and Control Tower are examples of the Nonrenovation projects.

Renovation Ceiling Costs. The FY 2000 Status Report to Congress primarily discussed the renovation of the building. The report also only briefly discussed the total obligations incurred to date for the Renovation Ceiling, which should cost approximately $642.2 million from FY 2000 to FY 2015. The report did not discuss the cost of the specific renovation projects. 10 U.S.C. 2674 does not specifically require the report to include cost information for the major projects, such as the Metro Entrance Facility. However, including such data would help the readers understand how the program management office is managing the challenges required by the spending limit.

Nonrenovation Costs. The FY 2000 Status Report to Congress does not provide an estimated cost of the Nonrenovation projects. From FY 2000 to FY 2015, this category may cost as much as $1.7 billion. The annual budget submission does discuss the cost of the major Nonrenovation projects. However, it does not present the total major construction costs that will be incurred throughout the life of the program. The WHS appropriately interpreted 10 U.S.C. 2674 and the congressionally imposed spending limit. As such, the Status Report to Congress is only required to discuss the Renovation Ceiling category, which consists of the costs of planning, design, construction and installation of equipment. However, all the major construction projects, regardless of their classification, are part of a major effort to modernize the Pentagon Reservation. Furthermore, they are primarily managed through the Pentagon Renovation Program.

The FY 2000 "Status Report to Congress on the Renovation of the Pentagon" did meet legislative intent of 10 U.S.C. 2674. The Status Report to Congress briefly discussed the Nonrenovation projects. Including additional cost information would present a more complete picture of the major construction efforts undertaken and challenges managed by the program management office. Including all the Pentagon Reservation major construction projects and their costs in the Status Report to Congress could also help readers appreciate the difficult project undertaken by the program management office.

Effects of the Initial Renovation Cost Projections

The Pentagon Renovation Program acknowledged that the $1.2 billion congressional spending ceiling represented an extreme challenge that would be difficult to achieve. Some of this difficulty resulted from not accounting for inflation costs in the initial projected budget for the renovation. As previously explained, the construction management team also encountered unexpected construction complications. For example, typical environmental abatement costs $6 to $10 per square foot. In comparison, environmental abatement at the Pentagon has cost roughly $25 per square foot due to lead based paint, asbestos, and mercury in the building. Furthermore, since the Pentagon was declared a National Historic Landmark, its special status placed significant restrictions on external renovation activities. It also presented several challenges to the renovation team.

To stay within the spending limit, the Pentagon Renovation Program responded by taking aggressive cost reduction initiatives. Furthermore, the Deputy Secretary of Defense, in his memorandum "Guidance for Continuing the Pentagon Renovation Program" dated May 17, 2000, directed the Program Management Office to prepare the basement for future use. This involved removing hazardous material and installing utilities but not preparing it for actual tenant use. Consequently, the program management office conducted an analysis of new construction initiatives, methods to use space more efficiently, and reconfigurations of planned furniture.

Based on plans prepared at the end of 1999, the program management office reduced the scope of the renovation by roughly $564.8 million. They made those changes by:

- recategorizing costs to the Nonrenovation category,
- leaving portions of the building unfinished,
- reducing the scope of the program, and
- changing their contracting methodology.

As the following table indicates, $300 million of those changes may affect the functionality and the operations and maintenance costs of the building in the long term.

Reduced Scope of the Pentagon Renovation
(in millions)

Renovation Project	Cost
Leave Pentagon basement unfinished	$213.93
Install two major escalators rather than five	2.36
Eliminate fifteen elevators	5.16
Eliminate tenant fit-out contingency	1.98
Eliminate construction contingency	7.70
Install cheaper locks	0.16
Move / reduce Military Command Centers	39.00
Reduced core / shell (increases maintenance)	7.72
Reduce building air flow control	6.00
Do not repair building light wells	16.00
Total	**$300.01**

The FY 2000 Status Report to Congress states that the program would not achieve some of the work and goals previously reported to Congress. The Pentagon Renovation Program will improve building operations and efficiency and improve the quality of life for building tenants. However, the report did not discuss the magnitude of the changes needed to keep the program within the congressionally mandated spending limit.

Similarly, the program management office reduced the scope of the Nonrenovation efforts by roughly $541.2 million. Those changes could have been more clearly reported in the FY 2000 Status Report to Congress. Even though the program management office was not required to report those costs, many of the Nonrenovation initiatives are related to the challenging effort to renovate the Pentagon Reservation. The reduced scope of the program had a sizable impact on the renovation efforts.

Furthermore, if the DoD attempts to complete the unfinished construction work (such as the basement and light wells) after the Pentagon Renovation Program finishes the "capped" renovation efforts, it could be more expensive for the Government. To perform the canceled projects after the renovation, the WHS would have to recreate the management structure and construction team that was in place during the renovation. The report will present a more complete picture of the difficulties associated with the renovation by including the following information:

- the reduced scope,
- the cost of those items, and
- the effects on future operations and maintenance costs caused by those changes.

Management Comments on the Finding and Audit Response

Management Comments. The Program Manager, Pentagon Renovation Program noted that the Pentagon Renovation Program performed an analysis of the project. They determined that all Pentagon employees temporarily housed outside the building could be moved back into the Pentagon without finishing the remaining segments of the basement. In addition, the Program Manager stated that the design alternatives and cost estimates had not been specifically approved or implemented. Thus, the Program Manager stated that they should be removed from the report.

Audit Response. The Pentagon Renovation Program did not officially approve or implement the design alternatives listed in the report. However, they did indicate the magnitude of significant evaluations and decisions made by the Pentagon Renovation Program. Excluding those cost estimates would minimize the magnitude and significance of the designs considered and rejected. Including those cost estimates illustrates the difficulties faced by the Program Management Office under the current spending limit. It also highlights the potential long term costs and benefits of the current plans.

Recommendations and Management Comments

B. We recommend that the Program Manager, Pentagon Renovation Program:

1. Prepare future Status Reports to Congress so they specifically identify the cost of major Renovation projects.

Management Comments. The Program Manager concurred and agreed to provide specific detail in the Fiscal Year 2002 Status Report to Congress.

2. Evaluate the appropriateness of:

a. Including an estimated cost for Nonrenovation projects in the Status Report to Congress.

Management Comments. The Program Manager concurred and agreed to evaluate the appropriateness of including an estimated cost for Nonrenovation projects in the Status Report to Congress. The Program Manager indicated that this would be an iterative process because of the emergent nature of some Nonrenovation project taskings.

b. Providing more detail in the Status Report to Congress about the reduced scope of the Renovation and the effect it might have on the functionality or the operations and maintenance of the building.

Management Comments. The Program Manager concurred and agreed to evaluate possible reductions in scope and the resulting effect. The evaluation will include determining the appropriateness of including this information in future Status Reports to Congress.

Appendix A. Audit Process

Scope and Methodology

Work Performed. We evaluated whether the PRMRF had properly recorded and reported the CIP costs. We also evaluated and reviewed the procedures and documentation used for cost projection and information reported to Congress in the FY 2000 Status Report to Congress. We reviewed the financial guidance provided by the Under Secretary of Defense (Comptroller) through the FMR. We inspected the PRMRF financial data sent to the Defense Finance and Accounting Service. At the U.S. Army Corps of Engineers - Baltimore District, we reviewed the financial process used to prepare the DD Forms 1354 and tested the supporting documents for the construction projects completed by the Corps.

We tested the accuracy of the $798.8 million CIP balance recorded in the FY 2000 year-end balance of the WHS Allotment Accounting System. We inspected the supporting documentation for the $179.8 million buildings account reported on the FY 2000 trial balance and the relevant real property accounting policies and procedures.

We reviewed the management control programs for the Defense Finance and Accounting Service, U.S. Corps of Engineers - Baltimore District, and the WHS Budget and Finance Directorate. To assess the adequacy of the FY 2000 Status Report to Congress, we reviewed the process and supporting documentation for the cost projections used by the Pentagon Renovation Program. Furthermore, we assessed the adequacy of the information disclosed in the report by comparing the program's internal documents, the fund's budget documents, and the requirements of the United States Code.

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

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

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

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

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to the achievement of the following functional area objective and goal.

- **Financial Management Area. Objective:** Strengthen internal controls. **Goal:** Improve compliance with the Federal Manager's Financial Integrity Act. **(FM-5.3)**

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

Use of Computer-Processed Data. We relied on computer-processed data from the WHS Allotment Accounting System used to maintain financial records for various appropriations and funds, including the PRMRF. We performed extensive tests on the database by tracing sampled data from the system to source documentation. We found the data reliable. However, as shown in the report, the balances of the CIP and real property accounts were found unreliable due to noncompliance with applicable regulations.

Audit or Evaluation Type, Dates, and Standards. We performed this audit from June 2000 through March 2001 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did our work in accordance with generally accepted Government auditing standards except that we were unable to obtain an opinion on our system of quality control. The most recent external quality control review was withdrawn on March 15, 2001, and we will undergo a new review.

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

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides a reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of WHS management controls over the accountability for construction costs. Specifically, we reviewed the WHS Budget and Finance Directorate management controls over recording CIP and real property costs into the WHS Allotment Accounting System. We also reviewed WHS FY 2000 Annual Statement of Assurance. We reviewed management's self-evaluation applicable to those controls.

Adequacy of Management Controls. We identified a material management control weakness for the WHS Budget and Finance Directorate as defined by DoD Instruction 5010.40. The Budget and Finance Directorate's management controls for recording and reporting construction costs, specifically the CIP and real property accounts, were not adequate. The controls did not ensure that the PRMRF CIP account included all of the applicable construction costs. The controls did not ensure that completed construction projects were properly transferred into the appropriate real property accounts. If implemented, Recommendation A will improve the accuracy and reliability of the financial reports. A copy of this report will be provided to the senior official responsible for management controls in the WHS.

Adequacy of Management's Self-Evaluation. WHS did not identify recording and reporting construction projects as an assessable unit. It did not identify or report the material management control weaknesses identified by the audit. Until it is corrected, future construction projects will result in errors in the CIP and real property accounts.

Prior Coverage

No prior coverage has been conducted on the subject during the last 5 years.

Appendix B. Pentagon Reservation Maintenance Revolving Fund Guidance in the Financial Management Regulation

The DoD incorporates the PRMRF into the Other Defense Organizations in the General Fund financial statements. However, because it was designed to operate on a break-even basis and collects funds through user charges, it functions like a Working Capital Fund.

Several chapters in the FMR discuss revolving funds and specifically mention the PRMRF. In those chapters, the fund's guidance has become outdated or provides conflicting definitions. For example, one part of the FMR describes the PRMRF as an intergovernmental revolving fund while another section describes the fund as a public enterprise fund.

The FMR also provides unclear budgeting data. Volume 2B, chapter 10 explains how to prepare a budget for the PRMRF, but it does not explain how to account for major construction. While a budget analyst could rely on volume 2B, chapter 6, "Military Construction/Family Appropriations," the FMR did not specifically refer the reader to this section. Moreover, this section was designed for construction funded by appropriations. The PRMRF primarily collects its funds through user charges.

The Office of the Deputy Comptroller (Program/Budget) stated that they were considering revising the FMR to provide clearer guidance for the WHS.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Director, Washington Headquarters Services
Program Manager, Pentagon Renovation Program

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army
Commander, U.S. Army Corps of Engineers

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

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

Other Defense Organization

Director, Defense Finance and Accounting Service
Director, Defense Contract Audit Agency
Director, Defense Logistics Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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

Washington Headquarters Services Comments

Final Report Reference

DEPARTMENT OF DEFENSE
WASHINGTON HEADQUARTERS SERVICES
1155 DEFENSE PENTAGON
WASHINGTON, DC 20301-1155

MAY 23 2001

MEMORANDUM FOR DoD INSPECTOR GENERAL
DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE

SUBJECT: Pentagon Reservation Maintenance Revolving Fund
(Project No. D2001FH-0045)

The subject draft audit report has been reviewed and the following comments are provided per your request.

General Comments:

Executive Summary, Results:

The inclusion of the $12.1 million value for the old heating and refrigeration plant had no effect on the financial position of the PRMRF. The net effect on the asset and equity accounts was zero since the $12.1 million of depreciation recorded in account 1739 offset the $12.1 million in the buildings account. The asset was fully depreciated.

The draft audit report states that the incorrect method was used to calculate depreciation. When the PRMRF was established in 1991, the straight-line method of depreciation was the preferred method. It was used for the Pentagon Reservation buildings and the completed improvement projects that were transferred to the fund from GSA. When the Department revised its policy on depreciation in October 1998, the new policy stated, "DoD Components shall not attempt to adjust the depreciation schedules of assets currently on-hand. However, the Mid-Year Convention is permitted, and recommended, if a DoD Component is computing depreciation for the first time." When this guidance was implemented, the majority of PRMRF improvement projects transferred from GSA had been fully depreciated and the buildings were over 80% depreciated using the straight-line method. Revised

Responses to Section A Recommendations:

Recommendation A1. Develop policies and procedures to accumulate overhead costs associated with the capital improvement projects to specific capital improvement projects in proportionate amounts.

Pentagon Renovation Comments. Concur. Representatives from Budget and Finance, Real Estate and Facilities, and the Pentagon Renovation Office will develop procedures for applying overhead to all construction in progress projects.

Estimated completion Date. October 1, 2001.

Recommendation A2. Establish policies and procedures to properly transfer completed construction projects from the construction in progress account to the real property accounts. The procedures should also include a process for creating and retaining appropriate supporting documentation for both additions and deletions to the real property account.

Pentagon Renovation Comments. Concur. Representatives from Budget and Finance, Real Estate and Facilities, and the Pentagon Renovation Office will develop procedures for the completion and distribution of the DD Form 1354, Transfer and Acceptance of Military Real Property, which will identify the appropriate construction costs for completed projects. These forms will be used as the source accounting document to post to the WHS Allotment Accounting System general ledger to transfer these costs from GLAC 1723, Construction in Progress, to GLAC 1730, Buildings.

Estimated Completion Date. October 1, 2001

Recommendation A3. Revise existing depreciation policies to bring them in conformity with Volume 4, Chapter 6 of the Financial Management Regulation, "Accounting Policy and Procedures – Property, Plant, and Equipment."

Pentagon Renovation Comments. Concur. The WHS Allotment Accounting System software will be changed to allow the use of the Mid-Year Convention method of depreciation for new assets. The current method of straight-line depreciation will continue to be used for assets already being depreciated.

Estimated Completion Date. October 1, 2001

Please call Mr. William Bader at 703-614-0971 with any questions.

We appreciate the opportunity to provide these comments.

D. O. Cooke
Director

Pentagon Renovation Program Comments

Final Report Reference

OFFICE OF THE SECRETARY OF DEFENSE
PENTAGON RENOVATION PROGRAM
100 BOUNDARY CHANNEL DRIVE
ARLINGTON VA 22202-3712

May 25, 2001

MEMORANDUM FOR DoD INSPECTOR GENERAL
DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE

SUBJECT: Pentagon Reservation Maintenance Revolving Fund
(Project No. D2001FH-0045)

The subject draft audit report has been reviewed and the following comments are provided per your request.

General Comments:

Page ii, Executive Summary, paragraph 2, second sentence – …the program management office reduced the scope of the renovation by roughly $564.8 million. This should more accurately state that the Renovation performed an analysis and determined that with new construction initiatives, more efficient use of space, and a better reconfiguration of furniture, we could bring all Pentagon employees presently housed outside the building, back in, without building out the two remaining segments of the basement. This resulted in an estimated cost avoidance of roughy $564.8.

Page 3-6, Section A – Comments on this section of the report will be forwarded by Washington Headquarters Services.

Page 9, paragraph 2 – See comment above for Page ii.

Page 9, paragraph 3 and boxed table – The table headed "Reduced Scope of the Pentagon Renovation" appears to be a selection from a working list of design alternatives, cost estimate changes and reduction in functionality of the Renovation prepared for internal use in late 1999. With the exception of changes to level of construction in the basement, these alternatives have not been specifically approved or implemented, and the cost reductions estimates associated with them are not current. Recommend this paragraph and table be deleted and replaced with the following statement: "The Deputy Secretary of Defense, in his memorandum of 17 May 2000, subject "Guidance for Continuing the Pentagon Renovation Program" directed that the basement not be built out, but prepared for future use as tenant space by hazardous material removal and installation of utilities. Subject memorandum also directed that due consideration be given to life cycle cost for the building in pursuing efficiency and containing costs."

Revised, Page 10

ON COST, ON SCHEDULE, BUILT FOR THE NEXT FIFTY YEARS

Responses to Section B Recommendations:

Recommendation 1. Recommend that the Program Manager, Pentagon Renovation Program prepare future Status Reports to Congress so they specifically identify the cost of major Renovation projects.

Penatgon Renovation Comments. Concur.

Estimated completion Date. March 1, 2002. Specifics will be included in the Fiscal Year 2002 Report to Congress.

Recommendation 2a. Recommend the Program Manager, Pentagon Renovation, evaluate the appropriateness of including an estimated cost for Nonrenovation projects in the Status Report to Congress.

Pentagon Renovation Comments. Concur. However, due to the emergent nature of some Nonrenovation project taskings, this evaluation will be part of an iterative process.

Estimated Completion Date. Program Manager, Pentagon Renovation, will initiate a review of projects currently known or planned for implementation on the Pentagon Reservation in coordination with Washington Headquarters Services and Service and Agency facilities planners to perform this evaluation of appropriateness for inclusion. Review will be completed 30 November 2001.

Recommendation 2b. Recommend the Program Manager, Pentagon Renovation Program evaluate the appropriateness of providing more detail in the Status Report to Congress about the reduced scope of the Renovation and the effect it might have on the functionality or the operations and maintenance of the building.

Pentagon Renovation Comments. Concur.

Estimated Completion Date. Program Manager, Pentagon Renovation, will initiate an evaluation of possible reductions in scope of the Renovation and any resultant effects, in coordination with Washington Headquarters Services, in order to dertermine appropriateness for inclusion of this information in the future Status Reports. Review will be completed 30 November 2001.

Please call Ms. Mary Lou Kueker at 703-693-8275 with any questions.

We appreciate the opportunity to provide these comments.

Walker Lee Evey
Program Manager

Audit Team Members

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

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