II. Financial Section

Office of the Inspector General Transmittal

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 9, 2018

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF FINANCIAL OFFICER, DOD
ASSISTANT SECRETARY OF DEFENSE (HEALTH AFFAIRS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Transmittal of the Independent Auditor's Report on the Defense Health Program Enterprise Financial Statements and Related Notes for FY 2018 (Project No. D2017-D000FT-0180.000, Report No. DODIG-2019-008)

We contracted with the independent public accounting firm of Kearney & Company to audit the Defense Health Program (DHP) Enterprise FY 2018 Financial Statements and related notes as of September 30, 2018, and for the year then ended, and to provide a report on internal control over financial reporting and compliance with laws and regulations. The contract required Kearney & Company to conduct the audit in accordance with generally accepted government auditing standards (GAGAS); Office of Management and Budget audit guidance; and the Government Accountability Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2008.[1] Kearney & Company's Independent Auditor's Reports are attached.

Kearney & Company's audit resulted in a disclaimer of opinion. Kearney & Company could not obtain sufficient, appropriate audit evidence to support the reported amounts within the DHP financial statements. As a result, Kearney & Company could not conclude whether the financial statements and related notes were presented fairly in accordance with Generally Accepted Accounting Principles. Accordingly, Kearney & Company did not express an opinion on the DHP FY 2018 Financial Statements and related notes.

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[1] In June 2018, the Government Accountability Office issued an updated Financial Audit Manual. Kearney & Company updated its audit procedures to be in accordance with the updates issued in the Government Accountability Office/Council of the Inspectors General on Integrity and Efficiency, "Financial Audit Manual," June 2018.

Kearney & Company's separate report on "Internal Control Over Financial Reporting" discusses 13 material weaknesses related to the DHP's internal controls over financial reporting. Specifically, Kearney & Company found material weaknesses related to: Entity-Level Controls; Financial Reporting; Fund Balance With Treasury; Accounts Receivable; Property, Plant, and Equipment; Inventory and Related Property; Accounts Payable and Related Liabilities; and Information Technology. Kearney & Company's additional report on "Compliance with Laws, Regulations, Contracts, and Grant Agreements" discusses four instances of noncompliance with applicable laws and regulations.

In connection with the contract, we reviewed Kearney & Company's reports and related documentation and discussed the audit results with Kearney & Company representatives. Our review, as differentiated from an audit in accordance with GAGAS, was not intended to enable us to express, and we did not express, an opinion on the DHP FY 2018 Financial Statements and related notes, conclusions about the effectiveness of internal control, conclusions on whether the DHP's financial systems substantially complied with the "Federal Financial Management Improvement Act of 1996," or conclusions on whether the DHP complied with laws and regulations.

Kearney & Company is responsible for the attached reports, dated November 9, 2018, and the conclusions expressed in these reports. However, our review disclosed no instances in which Kearney & Company did not comply, in all material respects, with GAGAS.

Signed

Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting

Attachments:
As stated

Independent Auditor's Report

KEARNEY& COMPANY

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INDEPENDENT AUDITOR'S REPORT

To the Assistant Secretary of Defense for Health Affairs and Inspector General of the Department of Defense

Report on the Financial Statements

We were engaged to audit the accompanying consolidated financial statements of the Defense Health Program (DHP) Enterprise (hereinafter referred to as the DHP), which comprise the consolidated balance sheet as of September 30, 2018, the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources (hereinafter referred to as the "financial statements") for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted the audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*. Because of the matters described in the Basis for Disclaimer of Opinion section below, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion that the financial statements are free from material misstatements when taken as a whole. The DHP disclosed in Note 1, *Summary of Significant Accounting Policies*, instances where its current accounting and business practices represent departures from accounting principles generally accepted in the United States of America. As a result, the DHP was unable to assert that the financial statements are presented fairly in accordance with accounting principles generally accepted in the United States of America. The DHP asserted to the following departures from accounting principles generally accepted in the United States of America:

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- Accrual accounting requirements per Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, and SFFAS No. 5, *Accounting for Liabilities of The Federal Government*
- Recognition and valuation requirements set forth in SFFAS No. 3, *Accounting for Inventory and Related Property*
- Liability requirements set forth in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, and SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*
- Recognition and valuation requirements set forth in SFFAS No. 6, *Accounting for Property, Plant, and Equipment*
- Revenue recognition requirements set forth in SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*
- Recognition and valuation requirements set forth in SFFAS No. 8, *Supplementary Stewardship Reporting*
- Recognition and valuation requirements set forth in SFFAS No. 10, *Accounting for Internal Use Software*
- Reporting and valuation requirements set forth in SFFAS No. 29, *Heritage Assets and Stewardship Land*
- The full cost provisions of SFFAS No. 4, *Managerial Cost Accounting Standards and Concepts*, as amended by SFFAS No. 30, *Inter-Entity Cost Implementation* and SFFAS No. 55, *Amending Inter-Entity Cost Provisions*
- Accounting and reporting requirements associated with restatements per SFFAS No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, and OMB Circular A-136, *Financial Reporting Requirements*
- Reporting requirements set forth in SFFAS No. 42, *Deferred Maintenance and Repairs: Amending Statements of Federal Financial Accounting Standards 6, 14, 29, and 32*
- Recognition and reporting requirements set forth in SFFAS No. 47, *Reporting Entity*.

We were unable to obtain sufficient appropriate evidential matter as to the completeness of the financial statements reported as of September 30, 2018. This includes $20.5 billion of Fund Balance with Treasury (FBWT), $1.0 billion of Accounts Payable ($325.0 million Federal and $676.2 million Non-Federal), $133.0 million in Other Liabilities ($98.9 million Federal and $34.1 million Non-Federal), and $15.6 million in Environmental and Disposal Liabilities balances on the balance sheet.

We were unable to obtain sufficient appropriate evidential matter to enable us to perform audit procedures to support the completeness and accuracy of the financial statements in accordance with accounting principles generally accepted in the United States of America and Department of the Treasury (Treasury) standard general ledger reporting requirements. The DHP is unable to reconcile its financial statements to supporting general ledger (GL) system trial balances and GL system transaction details without material variances. The DHP has also not completed an assessment to define its financial reporting entity to evidence completeness of its financial statements and related disclosures, including beginning balances, at the Enterprise or component levels.

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We were unable to obtain sufficient appropriate evidential matter as to the existence, completeness, and accuracy of the DHP's stockpile material reported within the Inventory and Related Property line item of the balance sheet. As of September 30, 2018, the DHP reported approximately $32.5 million of Inventory and Related Property on the balance sheet, consisting solely of stockpile material. The DHP did not record stockpile material in accordance with SFFAS No. 3. The DHP was unable to provide sufficient data to allow audit procedures to be performed over the existence, completeness, and valuation of stockpile material. In addition, the DHP has not performed the required assessment for Operating Materials and Supplies (OM&S) to support its accounting treatment selected under SFFAS No. 3. The DHP did not report OM&S within the Inventory and Related Property line item of the balance sheet, directly expensing OM&S upon purchase. The DHP was unable to provide sufficient evidence to support this method of accounting was appropriate based on prescribed conditions within SFFAS No. 3.

We were unable to obtain sufficient appropriate evidential matter to enable us to perform audit procedures to satisfy ourselves that the Property, Plant, and Equipment (PP&E) opening balances as of October 1, 2017 or ending balance balances as of September 30, 2018 were free of material misstatements. Our work identified issues related to existence, completeness, valuation, and disclosure of real property (including real property construction-in-progress), internal use software (including internal use software in development), and general equipment. As of September 30, 2018, the DHP reported $3.7 billion in net PP&E on its balance sheet.

We were unable to obtain sufficient appropriate evidential matter as to the completeness of revenue and associated accounts receivable. The DHP does not account for all revenue and accounts receivable transactions using the accrual basis of accounting, recording certain activity on the cash basis of accounting. As of September 30, 2018, the DHP reported $1.2 billion of accounts receivable ($463.6 million Federal and $701.9 million Non-Federal), net on its balance sheet and $3.7 billion of earned revenue on its statement of net cost.

The effects of the conditions described in the preceding paragraphs cannot be fully quantified, nor was it practical, given the available information, to extend audit procedures to sufficiently determine the extent of the misstatements to the financial statements. The effects of the conditions in the preceding paragraphs and overall challenges in obtaining sufficient audit evidence also made it impractical to execute all planned audit procedures. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary for the elements making up the DHP's financial statements.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion section above, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on these financial statements.

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Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis, other Required Supplementary Information, and Required Supplementary Stewardship Information (hereinafter referred to as the "required supplementary information") be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by OMB and the Federal Accounting Standards Advisory Board (FASAB), who consider it to be an essential part of the financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We were unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America because of matters described in the Basis for Disclaimer of Opinion section above. We do not express an opinion or provide any assurance on the information.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. Other Information as named in the Agency Financial Report is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements; accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01, we have also issued reports, dated November 9, 2018, on our consideration of the DHP's internal control over financial reporting and on our tests of the DHP's compliance with provisions of applicable laws, regulations, contracts, and grant agreements, and other matters for the year ended September 30, 2018. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01 and should be considered in assessing the results of our audit.

Kearney & Company

Alexandria, Virginia
November 9, 2018

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Assistant Secretary of Defense for Health Affairs and Inspector General of the Department of Defense

We were engaged to audit, in accordance with the auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*, the financial statements of the Defense Health Program (DHP) as of and for the year ended September 30, 2018, and we have issued our report thereon dated November 9, 2018. Our report disclaims an opinion on such financial statements because we were unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. The DHP also asserted to departures from generally accepted accounting principles.

Internal Control over Financial Reporting

In connection with our engagement to audit the financial statements, we considered the DHP's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the DHP's internal control. Accordingly, we do not express an opinion on the effectiveness of the DHP's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 19-01. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies; therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings, we identified certain deficiencies in internal control that we consider to be material weaknesses.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying Schedule of Findings to be material weaknesses.

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A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance. We noted certain additional matters involving internal control over financial reporting that we will report to the DHP's management in a separate letter.

The DHP's Response to Findings

The DHP's response to the findings identified in our engagement is described in a separate memorandum attached to this report in Section 2, *Financial Section*, of the Agency Financial Report. The DHP's response was not subjected to the auditing procedures applied in our engagement of the financial statements; accordingly, we do not express an opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the effectiveness of the DHP's internal control. This report is an integral part of an engagement to perform an audit in accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01 in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

Kearney & Company

Alexandria, Virginia
November 9, 2018

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Schedule of Findings

Material Weaknesses

The Military Health System (MHS), which is the global health system of the Department of Defense (DoD), is composed of medical personnel, infrastructure, and resources from the Departments of the Army, Navy, and Air Force, the Defense Health Agency (DHA), and the Office of the Assistant Secretary of Defense (Health Affairs). The Defense Health Program (DHP) appropriation serves as a funding source for the MHS. The DHP Enterprise financial statements are composed of the following component reporting entities:

- DHA Financial Operations Division (FOD)
- DHA Contract Resource Management (CRM)
- Uniformed Services University of Health Sciences (USUHS)
- Service Medical Activity (SMA) – Army/Army Medical Command (MEDCOM)
- SMA – Navy/Navy Bureau of Medicine and Surgery (BUMED)
- SMA – Air Force (AF)/Air Force Medical Service (AFMS)
- SMA – National Capital Region Medical Directorate (NCR-MD).

Throughout the course of our audit work with each DHP component reporting entity, internal control deficiencies were encountered which were considered for the purposes of reporting on internal control over financial reporting for the DHP. The material weaknesses presented in this Schedule of Findings have been formulated based on our determination of how individual control deficiencies, in aggregate, affect internal controls over financial reporting. The table below presents the material weaknesses identified during our audit:

Accounting Area	Material Weakness
Entity-Level Controls (ELC)	I. Governance Structure and Entity-Level Controls
Financial Reporting	II. Financial Reporting III. Universe of Transaction Reconciliations IV. Internal Controls over Defense Departmental Reporting System Journal Vouchers
Fund Balance with Treasury (FBWT)	V. Fund Balance with Treasury
Accounts Receivable (AR)	VI. Medical Revenue and Associated Receivables
Property, Plant, and Equipment (PP&E)	VII. General Equipment Existence and Completeness VIII. Valuation of Property, Plant, and Equipment IX. Real Property X. Internal Use Software and IUS In-Development
Inventory and Related Property	XI. Operating Materials and Supplies and Stockpile Material
Accounts Payable (AP) and Other Liabilities	XII. Liabilities
Information Technology (IT)	XIII. Information Systems

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I. Governance Structure and Entity-Level Controls (*New Condition*)

Deficiencies in two related areas define this material weakness:

A. Accounting and Financial Reporting Governance Structure
B. Entity-Level Control Design and Operation.

Background: Entity-level internal controls relate to an entity's control environment, risk assessment processes, information and communication, and monitoring of control effectiveness over time. They are enterprise-wide and have a pervasive effect on an entity's internal control system. The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires each Executive agency to establish and implement controls in accordance with standards prescribed by the Comptroller General of the United States, as codified in the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (the Green Book).

Agencies respond to these requirements by implementing Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*. In addition, components within the Department of Defense (DoD) use the Managers' Internal Control Program (MICP) to support their responses to these requirements.

Beginning October 1, 2018, the National Defense Authorization Act for Fiscal Year (FY) 2017 (NDAA) consolidated the administration of more than 400 hospitals and clinics currently run by the Army, Navy, and Air Force into a centralized management structure within the DHA. The transition of administrative responsibility of the Military Treatment Facilities (MTF) to the DHA was in process during FY 2018.

A. Accounting and Financial Reporting Governance Structure

Condition: The DHP does not have an effective enterprise-level accounting and financial reporting governance and oversight organization to achieve its accounting and financial reporting objectives and responsibilities.

The organizational hierarchy for the DHP components is unclear as it pertains to accounting and financial reporting governance. Specifically, SMA components align themselves with their respective Military Departments and have adopted department-specific accounting policies and procedures accordingly. The DHP components were not always responsive to requests made by the DHP or its senior leadership group to provide documentation to support the DHP MICP.

Further, the DHP does not have entity-wide accounting policy in significant accounting areas, including:

- FBWT
- General PP&E
- Inventory and Related Property

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- AR and Associated Revenue
- Financial Reporting.

Cause: The DHP financial management organization is evolving and does not yet have the ability to exercise authority and oversight over DHP components. The DHP did not have effective oversight structure in place to monitor components' accounting and financial reporting. The individual management of the DHP components, which are responsible for the execution of the DHP funding across the Army, Navy, Air Force, DHA, and Health Affairs, operate independently and have not yet effectively merged into a cohesive formalized accounting and financial reporting governance structure within the DHP.

Effect: Without an effective enterprise-wide financial management governance and oversight organization, inconsistent policies and procedures can lead to unreliable and inaccurate financial information. Further, SMA components frequently revert to guidance from their respective Military Departments, creating greater ambiguity and confusion.

Unclear delegation of authority and lack of organizational structure between the DHP and components results in ineffective monitoring, which may lead to control failures and potential misstatements to the financial statements. Without the ability to implement an effective internal control assessment program, the risk of producing inaccurate financial statements increases.

The lack of comprehensive enterprise accounting policy for significant business operations of the DHP contributed to departures from Federal Accounting Standards issued by the Federal Accounting Standards Advisory Board (FASAB), including;

- Accrual accounting requirements per Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, and SFFAS No. 5, *Accounting for Liabilities of The Federal Government*
- Recognition and valuation requirements set forth in SFFAS No. 3, *Accounting for Inventory and Related Property*
- Liability requirements set forth in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, and SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*
- Recognition and valuation requirements set forth in SFFAS No. 6, *Accounting for Property, Plant, and Equipment*
- Revenue recognition requirements set forth in SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*
- Recognition and valuation requirements set forth in SFFAS No. 10, *Accounting for Internal Use Software*
- The full cost provisions of SFFAS No. 4, *Managerial Cost Accounting Standards and Concepts*, as amended by SFFAS No. 30, *Inter-Entity Cost Implementation*
- Recognition and reporting requirements set forth in SFFAS No. 47, *Reporting Entity*.

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Recommendations: Kearney & Company, P.C. (Kearney) recommends that the DHP:

1. Develop and distribute a DHP governance policy that establishes formalized governance for all components of the DHP financial reporting entity.
2. Perform a gap analysis between current policy and procedures and the GAO Green Book standards. Address the gaps identified to strengthen financial management capabilities and oversight at the Enterprise level.

B. Entity-Level Control Design and Operation

Condition: The DHP did not meet the standards for an effective internal control system, as defined in GAO's Green Book. The DHP identified 94 ELCs, of which 12 were determined to be ineffectively designed. Of the remaining 82 controls, 72 were determined to be operating ineffectively. The DHP did not achieve any of the 17 GAO Green Book principles across the five components of internal control.

Cause: The DHP has not formally established a MICP to support the effective design and operation of ELCs. The DHP has not fully transitioned from component-based internal control programs to an Enterprise-wide program with formalized policies, templates, metrics, and procedures for components' adherence. Components do not fully participate in the DHP MICP; rather, they align with their respective Military Department.

When component data and documentation is received, they are not formally reviewed and analyzed to support the consolidated DHP annual Statement of Assurance (SOA) required under FMFIA.

Effect: Without an effective entity-level control program in place, DHP is susceptible to inefficient and ineffective operations, unreliable financial reporting, and noncompliance with laws and regulations.

Recommendations: Kearney recommends that the DHP establish a policy for the MICP that requires, at a minimum, the development of ELCs at the DHP and component levels that align with the DHP MICP. The policy should require both the DHP and individual components to:

1. Review Green Book standards and accompanying implementation guidance to design Enterprise-wide ELCs to be implemented at the DHP and component levels.
2. Perform a data call with each of the components to establish an understanding of the following:
   a. Component points of contact (POC).
   b. Key supporting documents, policies, and references identified within the components' current ELCs.
   c. Current programs, functions, and responsibilities to support the agency's compliance with the Green Book.
3. Update assessment criteria based on OMB Circular A-123, best practices, and knowledge of agency operations.

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4. Review FY 2017 and FY 2018 results and final test plans; update control activity inventory through annual risk assessment process, hold understanding meetings with DHP ELC POCs, and review existing agency documentation; and crosswalk the documented controls to the respective principle in DHP-approved templates.
5. Design standard templates that are updated to support the assessment strategy and document results at the principle and component levels to provide sufficient evidence to support the effective operation of internal controls.
6. Document identified instances of control gaps based on design assessment; evaluate the magnitude of impact, likelihood of occurrence, and nature of each deficiency; and develop recommendations for compliance and/or improvement.
7. Develop a risk assessment model for ELCs, considering work performed under the agency's Enterprise Risk Management (ERM) effort and the Green Book's principles.

II. Financial Reporting (*New Condition*)

Deficiencies in two related areas define this material weakness:

A. Definition of a Reporting Entity
B. DHP Consolidated Financial Statements.

Background: As part of the financial reporting process, the DHP is required to assess related entities and compile consolidated financial statements based on the results. FASAB issued SFFAS No. 47, *Reporting Entity*, effective for periods beginning after September 30, 2017. The standard guides preparers of Government-wide general purpose Federal financial reports (GPFFR) in identifying organizations to report as "consolidation entities" and "disclosure entities." Consolidated financial statements are prepared based upon these determinations.

To prepare its financial statements, the DHP utilizes a service organization. The service organization performs financial statement compilation and reporting using information provided by each of the DHP components within the Defense Departmental Reporting System (DDRS) – Budgetary (B) and DDRS – Audited Financial Statements (AFS).

A. Definition of DHP Reporting Entity

Condition: The DHP did not complete an assessment to define its financial reporting entity in accordance with SFFAS No. 47. While component reporting entities have been identified, the DHP has not completed a formal assessment of potential consolidation entities and disclosure entities for which the DHP and its components are accountable. For example, the DHP did not complete an assessment of its relationship and business activities with the Henry Jackson Foundation (HJF), across component reporting entities, to determine the impact over financial reporting and/or required disclosures.

The DHP has not implemented sufficient monitoring controls to verify that the financial statements have been completely and accurately prepared by its service organization in accordance with the DHP-defined reporting entity. The DHP has not established a formal

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process to periodically redefine and verify its financial reporting entity completeness and compliance with generally accepted accounting principles (GAAP).

The DHP has not adequately assessed its risk of financial statement material misstatements, nor established its monitoring of internal controls over financial reporting to prevent, detect, and correct material misstatements at the DHP level.

Cause: The DHP does not have a formal and effective process to accurately define its financial reporting entity to ensure the production of complete and accurate financial statements and related disclosures in accordance with GAAP.

Effect: The DHP is unable to assert to the completeness of its financial statements and related disclosures. The DHP's financial statements may be materially misstated by the omission of consolidation entities and/or disclosure entities for which the DHP or component reporting entities may be accountable.

Recommendations: Kearney recommends that the DHP:

1. Establish a formal process to annually assess and revalidate its GPFFR financial reporting entity for completeness in accordance with the provisions of SFFAS No. 47. The assessment should be formalized with appropriate review and approval from DHP senior leaders, as well as each component's reporting entity. The approved DHP reporting entity definition should be communicated to applicable stakeholders, including the DHP's service organization for financial reporting.
2. Maintain documentation to evidence the completion of the assessment, including the analysis performed, sources referenced, and conclusions reached. The DHP should establish a Standard Operating Procedure (SOP) to ensure this process is performed consistently at the DHP level and by each component reporting entity.
3. Review the compiled financial statements from its service organization for completeness and accuracy to verify the statements have been prepared in accordance with the DHP-defined reporting entity.

B. DHP Financial Statement Consolidation

Condition: The DHP, with its service organization, did not have an adequate control environment in place to produce complete and accurate DHP consolidated financial statements and related footnotes. For the Quarter (Q) 2 FY 2018 financial statements submission, the DHP provided a final DHP Balance Sheet that was out of balance between Total Assets and Total Liabilities and Net Position. For Q3, the DHP was unable to timely prepare a complete Q3 DHP financial statement package. The DHP, in conjunction with its service organization, manually prepared the DHP financial statements outside of DDRS-AFS. The Q3 DHP financial statement package was provided on October 1, 2018, more than 68 days after the financial statement preparation timeline. In Q4, the DHP's financial statements were still unable to be produced from DDRS-AFS, requiring manual preparation of the consolidated trial balance, financial

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statements, and footnotes, outside of the service provider's normal control environment for financial reporting compilation.

Cause: The DHP, with its service organization, did not implement processes or internal controls to effectively and timely review the DHP's financial statements to prevent and detect misstatements. Additionally, effective manual compensating controls were not in place to mitigate financial reporting risk of misstatement resulting from system limitations in compiling the DHP's financial statements.

Effect: The DHP, with its service organization, was unable to timely produce complete and accurate DHP financial statements, footnotes, and a supporting trial balance as of Q3 FY 2018 and Q4 FY 2018. The manual production of the Q4 DHP trial balance did not establish a reconcilable (i.e., auditable) link between the DHP component underlying general ledger (GL) details and adjusted trial balances to the DHP trial balance. Therefore, the DHP could not perform, the complete reconciliation of the DHP financial statements back to supporting component GL systems.

Recommendations: Kearney recommends that the DHP, in coordination with its service organization:

1. Ensure DDRS-AFS is properly configured to produce the DHP consolidated financial reports.
2. Ensure that the DHP is provided an opportunity to review System Change Requests (SCR) affecting the DHP and component financial reports.
3. Ensure the DHP consolidated financial reports are produced within the official DDRS-AFS reporting structure and are, therefore, subjected to the applicable reconciliation and edit checks.
4. Implement formal processes and procedures within the DHP to fully review, and approve as final, the DHP consolidated financial reports.

III. Universe of Transaction Reconciliations (*New Condition*)

Background: The DHP operates in a non-integrated systems environment with financial information from many systems feeding into various DHP component GL systems. DHP financial data are captured within component GL systems from several feeder systems. Monthly, the DHP's service organization transfers feeder files from the component GL systems to DDRS-B. The transmitted data from each GL system undergo a series of translations (e.g., pre-processing) and transfers (i.e., from DDRS-B to DDRS-AFS) and are updated by a variety of supported and unsupported financial statement adjustments to produce the DHP's financial statements.

The DHP developed the Universe of Transactions (UoT) containing transaction-level details to support the consolidated financial statement balances. To reconcile the UoT to each component's trial balances and the consolidated financial statements, the DHP established a reconciliation process using the Auditable Universe of Data – Intelligence Tool (AUD-IT) in FY

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2017. With the exception of DHA-CRM, all of the DHP's components have been included in the UoT reconciliation process. DHA-CRM receives a standalone audit and, therefore, is not included in the UoT reconciliation process. The UoT reconciliation process was developed to provide transaction-level details to support the DHP's financial statements.

The six DHP components included in the AUD-IT utilize seven GL systems. The overall reconciliation process includes reconciliation points to attempt to support the overall compilation of the DHP's financial statements from component GL systems to DDRS-B and to DDRS-AFS. The UoT reconciliation process consisted of three separate reconciliations for each component at the start of FY 2018 and was expanded to four separate reconciliations for each component, as well as two additional reconciliations at the DHP level, during FY 2018.

Condition: The DHP, in coordination with its service organizations, was unable to completely reconcile its UoT from the GL system trial balance through to the final DHP financial statements. The DHP could not sufficiently explain material variances between GL transaction details and GL system trial balances, as well as GL system trial balances and the final DDRS-AFS trial balance used for compiling the DHP's financial statements. Additionally, transactional records of financial feeder systems which bypass the DHP component GL systems have not been reconciled to journal voucher (JV) data recorded in DDRS.

The DHP cannot timely support the current reconciliation process for the financial statement balances. The DHP was unable to produce the UoT reconciliations over FY 2017 Q4, FY 2018 Q1, and FY 2018 Q2 to coincide with the delivery of final financial statements. Delivery of completed reconciliations ranged from six weeks after quarter-close to 10 weeks after quarter-close.

The DHP did not fully document the review and approval of reconciliations or complete checklists designed to support full completion of reconciliation steps.

Cause: The DHP did not maintain effective controls to ensure the UoT reconciliation process was complete and that all identified variances were supported. In addition, the DHP did not maintain service-level agreements (SLA) or Memorandums of Understanding (MOU) with its service organizations to establish official submission deadlines for key components of the reconciliation process performed each quarter.

Material variances were noted as a result of the lack of a formalized, repeatable, and auditable processes for the transformation of data from GL system GLACs which are not United States Standard General Ledger (USSGL)/Standard Financial Information Structure (SFIS)-compliant, to USSGL GLACs. The DHP and its service organization have not completed reconciliations of the DDRS feeder file transactional details to the summarized data recorded in DDRS.

The DHP's use of seven GL systems adds complexity, risk, and time to the overall reconciliation process. GL transaction-level data must be obtained, normalized, and reconciled before it is useable across each of the GL systems. Subsequently, the DHP is performing review and approval procedures for each reconciliation package of the seven GL systems. The end-to-end

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process cannot currently be performed in the compressed financial reporting timeline following quarter-end.

Effect: The DHP is unable to prepare financial statements reconciled to the supporting transaction-level data in a timely manner. The DHP management is unable to assert to the completeness and accuracy of the financial statements in accordance with GAAP and USSGL Department of the Treasury (Treasury) reporting requirements.

Recommendations: Kearney recommends that the DHP:

1. Complete formalized end-to-end reconciliation process policy or SOPs documenting the roles and responsibilities of each stakeholder with established timelines. The SOP should include documented steps for preparers and reviewers.
2. Develop formal SLAs and/or MOUs to establish a formal delivery timeline of the GL detail, trial balance detail, JV detail, and applicable reconciliation packages to the DHP subsequent to each quarter-end.
3. Monitor service organization progress in generating key components of the reconciliation process to allow for alternative procedures if extended delays are anticipated.
4. Develop an analysis of the financial statement impact of not having GL transaction data to fully reconcile to GL system trial balances. Additionally, the DHP should work with the AUD-IT service organization to obtain GL transaction data for no-year appropriation funds.
5. Coordinate with the service organization AUD-IT Team to develop oversight or review procedures to ensure all GL data is complete and includes all necessary records.
6. Coordinate with its service organization and applicable the DHP components to implement procedures to complete and document crosswalk reconciliations from GL system trial balances to DDRS trial balances to ensure completeness and accuracy from native GLAC to USSGL. The crosswalk reconciliations should be formalized to allow an external auditor to re-perform the crosswalking exercise from GL system trial balances to DDRS-B.
7. Continue the development and implementation of reconciliations for DDRS feeder file transaction details to summarized data within DDRS or ensure compensating controls are in place to ensure the completeness and accuracy of the data used in feeder file adjustments.

IV. Internal Controls over Defense Departmental Reporting System Journal Vouchers (*New Condition*)

Background: As part of the process of compiling the DHP's financial statements, the DHP's service organization for financial reporting posts monthly JV adjustments in the DDRS-B and quarterly JV adjustments and trial balance input adjustments (TBIA) in DDRS-AFS on behalf of the DHP components. The financial reporting service organization self-classifies each DDRS-AFS and DDRS-B JV as either "supported" or "unsupported."

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Included in the monthly and quarterly financial reporting processes are the posting of trading partner adjustments and elimination entries. There are two types of eliminations: 1) intra-DHP eliminations, which are those within the DHP and its components, and 2) inter-DHP eliminations, which are those outside of the DHP. Prior to execution of the elimination entries, trading partner seller-side adjustments are made. According to the DoD Financial Management Regulation (FMR), DoD's accounting and feeder systems do not capture trading partner information at the level required to facilitate intra-departmental trading partner reconciliations and subsequent eliminations. Therefore, the buyer-side balances are aligned with seller-side balances, as it is presumed that the amounts reported by the seller are more accurate than corresponding amounts reported by the buyer.

Condition: The DHP's financial statements contain material unsupported JV adjustments. Included in the financial statements are unsupported adjustments, as self-classified by the DHP's service organization. Of approximately 6,300 JVs recorded as of September 30, 2017 affecting the opening balances of FY 2018, 90% were classified as unsupported. This amounted to an excess of 5,500 unsupported DDRS-B JVs and six unsupported DDRS-AFS JVs and TBIAs.

During FY 2018, unsupported adjustments, as self-classified by the DHP's service organization, were posted on behalf of the DHP components in Q1 and Q2. Of approximately 2,000 JVs recorded as of March 31, 2018, 71% were classified as unsupported. This amounted to an excess of 1,400 unsupported DDRS-B JVs and thirteen unsupported DDRS-AFS and TBIAs.

The DHP, in coordination with its service organization, has not performed an assessment of the known unsupported JVs recorded to determine the impact of unsupported amounts reflected in the DHP financial statements.

The following service organization adjustments, self-classified as "supported," impacting the FY 2018 Q2 financial statement balances did not contain sufficient supporting documentation:

- Eight seller-side adjustments were not supported by underlying transaction-level details
- Twenty-one AR data call adjustments were not supported by underlying transaction-level details.

Trading partner seller-side adjustment JVs, recorded in DDRS-AFS to adjust the buyer-side intra-governmental transactions to the seller-side intra-governmental transactions, are unsupported as no underlying reconciliation of trading partner activity is performed to support the adjustments. DDRS elimination JVs (intra-DHP eliminations and inter-DHP eliminations) and reports at the DHP financial statement level lack evidence of review and approval.

Cause: The DHP financial reporting environment is complex, necessitating an inordinate volume of JVs to prepare financial statements. The DHP components do not share a common GL system, and each component utilizes a multitude of contributing feeder information systems. Many of these feeder systems and adjustments do not interface with DHP GL systems; rather, underlying activity is recorded directly into DDRS-B and DDRS-AFS via adjustment entries.

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The DHP does not exercise oversight of its components and its service organization to enforce the generation and retention of supporting documentation to maintain an audit trail. The DHP components have not developed business processes to ensure accounting events are fully supported by adequate underlying documentation.

The DHP has not established policies or procedures to reconcile intra-departmental transactions and balances with its trading partners. The DHP has not implemented appropriate or effective oversight of its service organization and has not adequately designed or implemented controls for appropriate review and approval over intra-DHP and inter-DHP trading partner eliminations for the DHP's financial statements.

Effect: As a result of the magnitude of unsupported JVs recorded during financial statement preparation, the DHP could not attest to the accuracy and completeness of its FY 2018 opening balances and the financial statement balances impacted by such adjustments recorded during FY 2018.

Recommendations: Kearney recommends that the DHP, in coordination with its service organization:

1. Analyze the unsupported DDRS-AFS JVs, DDRS-AFS TBIAs, and DDRS-B JVs to determine the nature of the adjustments. Results of this analysis should be used to identify the nature of the missing underlying support related to the unsupported adjustments. Upon completion of the analysis, a corrective action plan should be developed by JV category to set a path forward to resolve the underlying reason for the JV.
2. Coordinate with the DHP components and GL system owners to migrate monthly and quarterly adjustments, such as collections and disbursements, budget, and accountable property system of record (APSR) adjustments, to the DHP component GL systems which can accommodate USSGL reporting and transaction-level details.
3. Update or implement appropriate policies and procedures to facilitate coordination and communication between the DHP components and its service organization to obtain, maintain, and reconcile the underlying transaction-level data necessary to determine and support the monthly and quarterly adjustments for each DHP component and GL system to be entered at the DDRS-B and DDRS-AFS level.
4. Assess the unsupported JVs to determine the financial reporting impact to the DHP financial statements. The assessment should include appropriate detail to provide the percentage of significant financial statement line items which cannot be asserted for completeness and accuracy as a result of unsupported JVs included in the line item balance.
5. Implement policies and procedures for reconciling trading partner data at the transaction level based on the transactions and source documentation provided by trading partners. Once reconciliations are complete, the DHP should coordinate with its trading partners to adjust balances, as necessary, to reflect the actual amounts incurred and owed to trading partners based on the provision of goods and/or the receipt of services.

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6. Update relevant intra-DHP elimination policies and procedures to require its service organization to submit the intra-DHP eliminations with all appropriate and necessary JV support to allow for proper review to be performed by the DHP and to require the coordination directly with trading partners to develop processes for obtaining transaction details for intra-DHP eliminations.
7. Establish an SLA to ensure the trading partner elimination notifications occur within business hours, ensuring the DHP's availability for review and approval during the agreed-upon response window within the SLA.
8. Implement formal policies and procedures to perform and document the review of the intra-DHP and inter-DHP trading partner eliminations made on behalf of the DHP. This should include the development of an SOP to ensure that the review and approval process is consistently applied at the Enterprise level.

V. Fund Balance with Treasury (*New Condition*)

Background: The FBWT account represents the aggregate amount of funds available at the Treasury for which DHP components are authorized to make outlays. FBWT is increased by receiving appropriations, continuing resolutions, transfers-in, and offsetting collections, and it is decreased through rescissions and cancellations of budget authority, transfers-out, and disbursements.

All Treasury Index (TI) 97 Other Defense Organizations (ODO), including DHP components, are assigned specific limits which designate the amount or use of funds for a certain purpose or identify sub-elements within the account for management purposes. Federal agencies are required to reconcile FBWT at the limit level. Reconciling FBWT accounts with Treasury's Central Accounting Reporting System (CARS) records at least monthly helps ensure that balances are accurate and complete, differences are resolved in a timely manner, and financial statements are presented fairly. The DHP utilizes a service provider to perform monthly reconciliations between recorded amounts and those reported at Treasury.

In addition to supporting FBWT reconciliations, the service provider processes collections and disbursements and reports the DHP's total expenditure activity to Treasury on behalf of the Enterprise. Statements of Differences (SOD) arise when amounts reported to Treasury differ from actual disbursements and collections processed by financial institutions and the Treasury Regional Financial Centers. When reported transactions cannot be linked to a specific appropriation or reporting entity, they are placed into a DoD budget clearing (suspense) account for research and resolution.

Condition: The DHP experienced the following issues regarding the accuracy and completeness of collections and disbursements and related changes to FBWT:

- The DHP, in coordination with its service provider, does not have a complete, documented, end-to-end reconciliation process over FBWT

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- The DHP does not have controls over the monitoring of its service provider FBWT processes, including the review, approval, and monitoring of monthly FBWT reconciliations and variance resolution to ensure FBWT is accurate and complete
- The DHP's financial statements include an unsupported/unreconciled opening FBWT balance of $1.8 billion, or 9% of the DHP's opening FBWT balance
- FBWT reporting and reconciliation controls were not operating effectively and the DHP does not monitor or review its service provider processes to ensure FBWT is accurate and complete
- Cash Management Report (CMR) reconciliations, used to reconcile CARS to TI-97 ODO limits balances, are not properly designed and contain a $227.2 million unreconciled difference between CARS and the CMR related to Treasury Account Symbol (TAS) 97130130
- A monthly reconciliation is not performed between the CMR and DHP components' trial balances at the limit level after all adjustments are recorded
- The CMR has unreconciled collection and disbursement differences that could increase or decrease DHP components' limit balances.

The DHP, in conjunction with its service provider, has not implemented internal control activities to help ensure completeness of the DHP's financial statements with respect to identifying and properly recording actual or estimated suspense and SOD balances.

Cause: The DHP, in coordination with its service provider, has not designed all necessary internal control activities or documented its end-to-end FBWT reporting and reconciliation process and associated risks. To further complicate the process, Treasury does not report FBWT at the limit level below the TAS, inhibiting the DHP components' abilities to reconcile directly with Treasury.

FBWT reporting and reconciliation controls performed on behalf of the DHP are ineffective due to incomplete policies and procedures, ineffective management review and approval, failure to adhere to defined policies for timeliness, and a lack of consistent policy requirements across service provider locations. The DHP and its components have not formally developed and implemented oversight procedures or mitigating controls to compensate for the risk of ineffective controls over the FBWT reconciliation process.

Effect: The DHP may not be able to assess the potential risks to the accuracy and completeness of FBWT without a complete end-to-end reconciliation process, and the DHP may be unable to determine the total unsupported differences between its recorded FBWT and the balance reported in CARS. Without aggregating and reconciling component-level FBWT reconciliations, DHP management may also be unaware of a potential risk of a financial statement misstatement.

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Recommendations: Kearney recommends that the DHP, in coordination with its service provider:

1. Develop an accounting policy for FBWT which specifically addresses the requirements for a complete end-to-end FBWT reconciliation process to be performed at the component and DHP levels.
2. Identify impediments to the TI-97 FBWT reconciliation process (e.g., excluded activity from the CMR, TI-97 suspense accounts) and develop compensating controls at the DHP and component levels to reconcile any excluded FBWT activity or, through documented materiality analysis, indicate that management accepts the risk of potential misstatement.
3. Establish DHP and component oversight procedures over FBWT processes performed, including identifying and documenting roles and responsibilities for FBWT reconciliations, reviewing and approving reconciliations performed, and performing causative research, for reconciling items identified on a monthly basis.
4. Work with Treasury to determine the feasibility of adding subaccounts to basic symbols (e.g., 0130, 0500) to allow the DHP and its components to reconcile directly with Treasury.
5. Work with applicable parties to transition away from using monthly Non-Treasury Disbursing Office reporting to daily Treasury Disbursing Office.
6. Develop and implement a methodology to identify the actual or estimated impact of SOD and budget clearing accounts for recording and reporting into the GLs and financial statements.
7. Develop, implement, and document an effective reconciliation process for identifying any unmatched disbursements and collections and ensure that all resulting adjustments are fully supported at the DHP component level.
8. Review unidentified CMR differences and provide supporting information to clear differences.
9. Research and resolve suspense transactions by correcting the transactions in source systems and assist with necessary supporting documentation for corrections, if needed.

VI. Medical Revenue and Associated Receivables (*New Condition*)

Background: The DHP and its SMA components provide health support for military operations. The DHP and its SMAs process both billable and non-billable medical encounters that arise from performing medical services. Billable encounters are processed for patient care provided to non-TRICARE beneficiaries or for patient care provided to TRICARE beneficiaries who are either uncovered or covered by other insurance. Billing consists of the MTF sending invoices to patients or agencies for medical services provided. The SMAs utilize a billing and collection system as a subsidiary ledger to track and process collections on medical billings.

SMA MTFs also provide medical services for beneficiaries that are dual-eligible under Medicare, as well as Federal beneficiaries of the United States Coast Guard (USCG), Public Health Service (PHS), National Oceanic and Atmospheric Administration (NOAA), and Department of Veterans Affairs (VA). Payment for services provided to such beneficiaries varies based on established agreements with each entity.

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Condition: The DHP SMA components do not account for revenue or AR resulting from medical services provided in a consistent manner in accordance with GAAP. Not all SMA components record revenue earned from medical services provided on an accrual basis; rather, revenue is recorded on a cash basis. Monthly JVs recorded by the DHP's service organization to correct the cash basis of accounting for public services provided was not performed for all SMA components or contained posting logic errors, or complete transaction-level detail supporting the JV was not provided in response to the audit request. No process is in place to completely correct the cash basis of accounting for Federal services provided for the DHP.

The DHP SMA components receive quarterly prospective payments in advance of care provided from two Federal trading partners. The accounting for prospective payments is not consistent across the SMAs. The SMAs either recognize revenue upon receipt of payment prior to performing services, which is not in accordance with GAAP, or recognize the prospective payments as unearned revenue with periodic recognition over time based on actual care provided or historical data. The DHP did not perform an assessment to validate that the periodic recognition of revenue based on historical data was appropriate, rather than actual care provided in the current FY.

The DHP was unable to provide sufficient audit evidence to support the validity of AR balances within the billing and collection subsidiary ledger. AR transactions were noted as invalid because they were previously collected and never closed in the system, or the DHP could not provide sufficient documentation to support amounts billed for services provided.

Cause: The DHP has not formulated Enterprise-wide accounting policies or guidance for its components to ensure consistent and accurate accounting of medical services provided in accordance with GAAP.

SMAs have not established effective business processes with associated internal controls to properly recognize medical service revenue and associated AR using the accrual basis of accounting. In addition, specific to Federal prospective payments received for care to be provided, the SMAs have not established an effective business process with associated internal controls to properly recognize revenue based on care provided from actual activity occurring in the current FY.

The DHP has not established effective business processes to properly perform billing, collecting, and recording of medical AR with the public in its subsidiary system. The DHP did not develop, maintain, or provide sufficient documentation to adequately support the reported medical AR with the public.

Effect: The DHP's financial statements may contain misstatements associated with AR and Other Liabilities on the Balance Sheet, as well as Revenue and Expenses on the Statement of Net Cost. In addition, any unrecorded Federal AR would result in the understatement of Spending Authority from offsetting collections presented on the Statement of Budgetary Resources.

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The lack of Enterprise-wide policies and guidance for the accounting treatment of medical services resulted in inconsistent accounting treatment across the SMAs, as well as noncompliance with Federal accounting standards and, accordingly, the FFMIA.

Recommendations: Kearney recommends that the DHP develop an accounting policy for medical services revenue and associated AR, which specifically addresses the appropriate accounting treatment as prescribed within SFFAS No. 1 and SFFAS No. 7. The accounting policy should be developed through coordination with all SMAs. In addition, DHP SMAs should also perform the following:

1. Establish formalized business processes to record medical service revenue and associated AR in the GL system at the time of billing from the medical billing system.
2. Formalize revenue recognition procedures for Federal trading partners to be aligned with actual care provided in the current FY. Revenue recognized should be supported by transactional activity recorded in the GL system.
3. Design and implement a process to verify collected patient billings are appropriately closed in the subsidiary ledgers. Monitoring controls should be established, to include performing a reconciliation between aged AR balances in the subsidiary ledger and collections to ensure that invalid AR entries have been closed.
4. Supporting documentation and retention requirements should be strengthened to evidence the validity of patient billings.

VII. General Equipment Existence and Completeness (*New Condition*)

Background: FASAB defines general equipment (GE) as all personal property that is functionally complete for its intended purpose, durable, and nonexpendable. Additionally, GE typically has an expected service life of two or more years, is not intended for sale, does not ordinarily lose its identity or become a component part of another article when put into use, and has been acquired (or constructed) with the intention of being used.

Condition: The DHP did not record GE in a consistent manner across component reporting entities. One DHP component is in possession of GE assets whose purchase price was greater than DoD's capitalization threshold in place for DoD PP&E. However, the component did not capitalize any GE within the opening balances reported for FY 2018, and no GE was recorded during FY 2018. The component does not have formal policies or procedures documenting its operational processes and controls to identify, track, record, and value its GE in accordance with GAAP, as promulgated by FASAB.

The remaining DHP components did not demonstrate sufficient existence and completeness for GE which was recorded as part of opening balances for FY 2018. The DHP could not locate or did not provide sufficient audit evidence to support the existence for 3% of 819 tested assets. The DHP did not record approximately 11% of 353 tested assets, which were selected while performing testwork at DHP MTF locations (i.e., completeness of DHP recorded assets).

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Cause: The DHP has not implemented policies, procedures, or internal controls to identify, recognize, and report capitalizable GE for all component entities. The DHP is currently in the process of completing its assessment of capitalizable GE at various locations and, therefore, has not yet finalized its approach to valuing GE.

Existence and completeness exceptions over GE are due to the lack of effective inventory management controls, inaccurate reporting of assets within the APSR, and lack of effective retention of supporting documentation.

Effect: The DHP components' lack of effectively designed and implemented controls resulted in the loss of accountability for asset custodianship and unsupportable financial reporting over PP&E, causing the DHP to misstate the balance of PP&E.

Recommendations: Kearney recommends that the DHP:

1. Establish an Enterprise-wide accounting policy to require annual inventory of GE, tracking GE, and proper cost classification in accordance with SFFAS No. 6, to include appropriate footnote disclosures.
2. Finalize SOPs surrounding annual inventory and accountability procedures in accordance with the DoD FMR and DoD Instructions (DoDI) 5000.64.
3. Complete ongoing efforts to verify the existence and completeness of GE for the purpose of bringing the GE portfolio to record for financial reporting. Obtain the latest inventory results and reconcile to GE recorded in the APSR. The DHP should also perform variance resolution and make adjustments to the APSR, as appropriate.
4. Perform a final assessment of available supporting documentation based on the known exceptions from testwork. Adjustments to the component APSRs should be recorded to remove known existence exceptions and add any remaining known completeness exceptions from the asset detail schedule.
5. Disseminate the GE existence and completeness audit testing results to all equipment custodians to promote awareness of the impact that effective inventory management controls have on property accountability.
6. Adhere to criteria and internal guidance related to the proper storing of documentation to support the acquisition, transfer, and disposal of GE.

VIII. Valuation of Property, Plant, and Equipment (*New Condition*)

Background: DHP components own, operate, and maintain stewardship of a diverse and significant portfolio of PP&E. The DHP has determined the asset classes for its PP&E as follows: GE; construction in-progress (CIP); IUS; IUS in-development; heritage assets; leases; and leasehold improvements. The DHP reported PP&E, net of accumulated depreciation and accumulated amortization, to be $3.7 billion.

In August 2016, FASAB issued SFFAS No. 50, *Establishing Opening Balances for General Property, Plant, and Equipment*, amending existing PP&E accounting standards to allow a reporting entity, under specific conditions, to apply alternative valuation methods in establishing

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opening balances for PP&E. The alternative valuation methods available under SFFAS No. 50 may be applied in the first reporting period in which the reporting entity makes an unreserved assertion that its financial statements are presented fairly in accordance with GAAP. As SFFAS No. 50 is applicable to the valuation of opening balances only, all changes to the DHP PP&E portfolio as a result of current-year transactions are subject to the valuation requirements set forth in SFFAS No. 6.

Condition: The DHP PP&E valuation as of September 30, 2018 is not in accordance with GAAP. The DHP disclosed that the opening balances of PP&E have not been valued at historical cost in accordance with valuation techniques promulgated by either SFFAS No. 6 or SFFAS No. 50.

Cause: The DHP has not established effective business processes, internal controls, or information systems necessary to accurately value PP&E in accordance with SFFAS No. 6. The accumulation of historical cost information with supporting documentation for PP&E acquisitions has not been appropriately maintained to support acquisition costs recorded in property systems. While the DHP intends to elect the alternative valuation techniques within SFFAS No. 50 to report property balances, they were not ready to make the election within FY 2018.

The DHP has not formulated accounting policy or accounting guidance from an Enterprise level to be issued to its components to appropriately value PP&E at historical cost in accordance with GAAP. As new accounting guidance was released by FASAB, no formal assessment of the DHP PP&E portfolio was performed from an Enterprise perspective or at the component level to determine if implementation of alternative valuation techniques afforded by SFFAS No. 50 was necessary across the components.

Effect: The DHP was unable to accurately and appropriately value its PP&E assets for FY 2018 in accordance with GAAP. The lack of accounting policy from an Enterprise perspective resulted in a lack of preparedness at the component level to re-value FY 2018 PP&E opening balances at historical cost in accordance with SFFAS No. 50.

The opening balances for FY 2018 did not reflect historical cost in accordance with GAAP, and the DHP did not have a remediation timeline to bring PP&E valuation GAAP-compliant by FY 2018 year-end. The DHP's recorded balance for PP&E of $3.7 billion, net of accumulated depreciation and accumulated amortization, may be materially misstated as presented within the DHP's financial statements.

Recommendations: Kearney recommends that the DHP:

1. Develop an Enterprise-wide accounting policy for PP&E which specifically addresses historical cost valuation in accordance with SFFAS No. 6 and SFFAS No. 50. In its determination to implement historical cost valuation for opening balances under SFFAS No. 50, the DHP must maintain PP&E processes with supporting internal controls that

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are both designed and operating effectively to value new PP&E acquisitions at historical cost in compliance with SFFAS No. 6.
2. Reference FASAB's Federal Financial Accounting Technical Release (TR) No. 18, *Implementation Guidance for Establishing Opening Balances*, dated October 2, 2017.
3. Retain appropriate key supporting documentation for underlying valuation methodology.
4. Document the valuation technique by asset class for all assets currently in the DHP PP&E portfolio.
5. Establish a timeline for the valuation and steps that each component is required to perform.
6. Detail requirements for valuation of new acquisitions that are compliant with SFFAS No. 6.

IX. Real Property (*New Condition*)

Background: DHP components own, operate, and maintain stewardship of a diverse and significant portfolio of PP&E Real Property (hereafter referred to as real property). Health care provided by the DHP is delivered in MTFs, which constitute more than 55 full-service hospitals and over 370 clinics located on military installations around the world.

Condition: The DHP did not record real property, in use by its components, on the DHP financial statements. The DHP did not record real property as part of the PP&E opening balance as of October 1, 2017, and real property was not subsequently added during interim reporting periods as of March 31, 2018 and June 30, 2018 or year-end reporting as of September 30, 2018.

Cause: The DHP did not record real property in its financial statements for FY 2018 in accordance with existing DoD-wide accounting policy. The decision to withhold real property from the DHP's financial statements was based on anticipated revisions to DoD-wide accounting policy related to the financial reporting responsibilities of real property for the DoD.

The DHP did not develop an accounting policy or standard guidance for component reporting entities to value and record real property.

Effect: The DHP did not comply with SFFAS No. 6 in the accounting treatment and financial reporting of real property. General PP&E, as presented on the Balance Sheet, was understated by the omission of the DHP's real property. In addition, any corresponding depreciation expense was understated on the Statement of Net Cost. The DHP cannot quantify the potential understatement to PP&E on its financial statements.

The lack of a formal policy to value and report real property could result in inconsistent reporting, as well as a material understatement of real property and depreciation on the DHP's financial statements when the DHP elects to record real property.

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Recommendations: The DHP should evaluate GAAP and existing DoD-wide policy and record real property appropriately. Kearney further recommends that the DHP:

1. Conduct an existence and completeness review of all real property (e.g., facilities, linear structures) associated with the DHP's health support for all military operations. Working with the U.S. Navy, Army, and Air Force, the DHP should make a determination as to which reporting entity meets the FASAB requirements for ownership and recognition of real property.
2. Incorporate real property in the development of the DHP accounting policy for PP&E. As recommended above at Section VII, *Valuation of PP&E*, the accounting policy should specifically address historical cost valuation in accordance with SFFAS No. 6 and SFFAS No. 50.
3. Upon release of new accounting policy for the DoD-wide, assess the policy with GAAP and develop an implementation strategy for the DHP-identified real property assets, as appropriate.

X. Internal Use Software and Internal Use Software In-Development (*New Condition*)

Background: Internal use software (IUS) includes application and operating system programs, procedures, rules, and any associated documentation pertaining to the operation of a computer system or program that an entity uses in operations or for other internal use. IUS does not include software embedded in military equipment, nor does it include software used in Special Test Equipment. IUS may be acquired through commercial off-the-shelf (COTS) purchases, developed by entity employees, or developed by contractors to the entity.

IUS owned by the DHP includes the Armed Forces Billing and Collection Utilization Solution (ABACUS), Composite Health Care System (CHCS), and Defense Medical Logistics Standard Support (DMLSS). In addition, the DHP is currently implementing a new electronic health record (EHR), MHS GENESIS, for the MHS to manage inpatient and outpatient medical and dental information for more than 9.4 million DoD beneficiaries.

As previously detailed in Section VIIValuation of , *Valuation of PP&E*, DHP management did not make an unreserved assertion as it pertains to the implementation of SFFAS No. 50. Without an unreserved assertion for SFFAS No. 50, the governing FASAB standard for the DHP's IUS is SFFAS No. 10.

Condition: The DHP's opening balance valuation of IUS, including IUS in-development, is not in accordance with GAAP. The DHP did not record IUS as part of opening balances of PP&E for FY 2018. The DHP did not begin valuation efforts over IUS using alternative valuation techniques in accordance with SFFAS No. 50, and it is unable to value IUS at historical cost in accordance with SFFAS No. 10.

Cause: With the DHP's intent to implement SFFAS No. 50 for IUS valuation, there has been an historical lack of effective business processes, internal controls, and information systems in place to accurately account for IUS in accordance with SFFAS No. 10. The DHP has not implemented

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policies, procedures, or internal controls to inventory IUS currently in use, track IUS projects in-development, or determine appropriate cost classification of expenditures for proper financial reporting.

The DHP has not finalized its approach to valuing IUS in accordance with SFFAS No. 50 for opening balances and SFFAS No. 10 after opening balances have been established.

The DHP has not performed a complete assessment of operational business processes to determine the financial reporting impact and proper accounting treatment of operations. Specific to the MHS GENESIS project, the DHP has not performed an assessment to determine the appropriate accounting classification as IUS or IUS in-development. The DHP was unable to obtain cost information to begin required analyses for classification and valuation efforts.

Effect: The DHP was unable to accurately account for the existence, completeness, or valuation of IUS in accordance with Federal accounting standards. The opening balance of PP&E on the Balance Sheet is understated by the omission of IUS and IUS in-development. The DHP was unable to quantify the misstatement on its financial statements.

Recommendations: Kearney recommends that the DHP:

1. Develop an accounting policy for IUS. The policy should provide for annual inventory of IUS, tracking IUS in-development, proper cost classification, and proper valuation in accordance with SFFAS No. 50 and SFFAS No. 10.
2. Continue pursuing expanded functionality in the IUS APSR to track and inventory IUS and IUS in-development to support the completeness and valuation of the IUS balance.
3. Develop annual inventory and accountability procedures in compliance with the DoD FMR and DoDI 5000.76, *Accountability and Management of Internal Use Software*.
4. Design and implement formalized internal controls for proper cost classification associated with IUS in-development to facilitate the identification and reporting of capitalizable costs.
5. Ensure, as part of the annual SOA, that IUS is incorporated as an assessable unit. Risk assessment procedures should be conducted to identify financial reporting risks associated with IUS and the extent of internal controls in place to address identified risks, as well as to identify internal control gaps which may exist.

XI. Operating Material and Supplies and Stockpile Material (*New Condition*)

Deficiencies in two related areas define this material weakness:

A. Enterprise Assessment of Operating Material and Supplies (OM&S)
B. Policies, Procedures, and Controls Surrounding Stockpile Materials Held by the DHP.

Background: SFFAS No. 3 defines OM&S as tangible personal property to be consumed in normal operations with the exclusion of: 1) goods that have been acquired for use in constructing real property or in assembling equipment to be used by the entity; 2) stockpile materials;

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3) goods held under price stabilization programs; 4) foreclosed property; 5) seized and forfeited property; and 6) inventory. Per SFFAS No. 3, the consumption method of accounting must be applied unless it is: 1) not significant amounts; 2) in the hands of the end user; or 3) if not cost-beneficial to apply the consumption method, the purchases method may be applied. The DHP components' OM&S encompasses pharmaceuticals, pharmaceutical medical supplies, and non-pharmaceutical medical supplies needed for MTFs.

DHP components are also required to maintain various medications for the DoD in the event a medical epidemic reaches the United States. The DHA component maintains SLAs with Federal entities to purchase medications on behalf of DHA. DHA also maintains SLAs to store and distribute medication materials for medical preparedness. Medications purchased for DHA by other Federal entities remain at the manufacturing facility until such time that they need to be administered throughout the DoD.

A. Enterprise Assessment of OM&S

Condition: The DHP has not performed an annual assessment of OM&S for the purposes of determining appropriate accounting treatment under SFFAS No. 3. Currently, OM&S acquired has been directly expensed as allowable under SFFAS No. 3; however, the DHP has not conducted a formalized annual assessment of its OM&S portfolio to determine whether directly expensing acquisitions is appropriate. The DHP has not documented its determination of whether OM&S are significant amounts, in the hands of the end user for use in normal operations, or if it is cost-beneficial to capitalize OM&S.

Cause: The DHP has not developed and implemented policies and procedures to ensure that OM&S acquired by component reporting entities are appropriately and accurately accounted for and captured in the DHP's financial statements in accordance with Federal accounting standards.

Effect: The opening balance of Inventory and Related Property, as required to be reported on the DHP Balance Sheet and disclosed in the supporting footnotes, may be incomplete and the corresponding expenditures associated with the purchase and issuance of OM&S may be misstated on the Statement of Net Cost.

Recommendations: Kearney recommends that the DHP:

1. Develop and implement a strategy to perform an annual assessment to support the elected accounting treatment for OM&S under SFFAS No. 3.
2. Support the assessment with formalized documentation, evidencing the selected criteria and applicable analysis.

If the DHP is unable to support one of the three criteria required for directly expensing OM&S acquisitions, Kearney recommends that the DHP:

1. Develop and implement a strategy to verify the existence, rights and obligations, valuation, and completeness of OM&S at the DHP and component levels.

2. Evaluate flexibilities provided by SFFAS No. 48, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials*, to establish opening balances.
3. Develop a DHP strategy for valuing, recording, maintaining (accountability), and reporting OM&S to provide guidance to the components.
4. Develop an Enterprise-wide policy to define the appropriate accounting treatment, recording, and financial reporting of OM&S.

B. Policies, Procedures, and Controls Surrounding Stockpile Materials Held by the DHP

Condition: The DHP components did not account for stockpile material in accordance with requirements set forth in SFFAS No. 3. Throughout FY 2018, the DHP incorrectly expensed stockpile material upon purchase, rather than appropriately capitalizing the material on the Balance Sheet. In Q4 of FY 2018, the DHP recorded an adjustment of approximately $32.5 million of stockpile materials as of September 30, 2018. The DHP was unable to support the balance recorded.

Cause: The DHP management has not developed and implemented DHP policies and procedures to ensure that stockpile materials are appropriately and accurately captured in the financial statements. In addition, the DHP has not performed a complete assessment of operational business processes to determine the financial reporting impact and proper accounting treatment of operations.

Effect: The opening balance of the Inventory and Related Property line item is understated by the stockpile materials held by the DHP. Additionally, period expenses may be overstated by any stockpile material acquisitions that have occurred to date in FY 2018 which were not appropriately captured in recording stockpile as of September 30, 2018.

Due to the lack of controls surrounding stockpile acquisitions and tracking, the DHP was unable to support the value of stockpile material recorded or determine the value of any misstatement.

Recommendations: Kearney recommends that the DHP:

1. Develop financial reporting policies and procedures to ensure that the DHP's operational business processes are reviewed to determine the appropriate accounting treatment, recording, and financial reporting impact.
2. Incorporate stockpile material as an assessable unit within the DHP MICP.
3. Implement policies, procedures, and controls for the end-to-end business process of stockpile materials. The policy, procedures, and controls should be developed to formally cover acquisition, receipt, issuance, transfers, inventory management, and disposal activities.
4. Complete ongoing efforts to verify the existence and completeness of DHP-owned stockpile material for the purpose of bringing the portfolio to record for financial reporting.

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5. Complete ongoing efforts to value stockpile material in accordance with Federal accounting standards. The DHP should consider the valuation techniques within SFFAS No. 48 in establishing its opening balance of stockpile material.
6. Establish appropriate accounting policy to value new acquisitions and the consumption of existing stockpile material in accordance with SFFAS No. 3. New acquisitions should be recorded using the consumption method of accounting defined in SFFAS No. 3.

XII. Liabilities (*New Condition*)

Background: During the normal course of operations, Federal agencies incur certain economic events that give rise to amounts owed to external entities. These liabilities can include, among others, AP for goods and services received from and progress in contract execution made by other entities excluding those services rendered by employees; unfunded leave representing unpaid leave that is earned and to which employees are entitled upon separation; Environmental and Disposal Liabilities (E&DL) for the cleanup costs associated with removing, containing, and/or disposing of hazardous waste or property that consists of hazardous waste; and loss contingencies for pending or threatened litigation and possible claims and assessments.

The Federal Employees Compensation Act (FECA) actuarial liability includes the expected liability for death, disability, medical, and other approved costs. The Department of Labor (DOL) administers FECA and sends Federal agencies the actuarial liability estimates for future workers' compensation benefits. In addition, DOL makes actual payments for workers' compensation benefits and then sends annual bills to the employing agencies in the chargeback process.

Condition: The DHP does not completely account for its liabilities and related expenses. Specifically, the DHP and its components have not completely recorded estimated AP for goods and services received but not yet billed in accordance with SFFAS No. 5. The DHP has not completely recorded other classes of liabilities and lacks internal control activities to help ensure the proper accounting of liabilities. The following transaction classes were either not considered by the DHP components or were not consistently recorded across components:

- Unfunded annual leave liability
- E&DL and the related expense
- Contingent or actual liabilities and related expense
- FECA liabilities, both actuarial and actual.

Cause: DHP components have not designed and implemented an effective internal control within respective procurement processes to ensure goods and services received but not yet paid for are appropriately accrued.

Specific to unfunded annual leave, one SMA component could not differentiate leave information between the SMA level and the respective Military Department level within the Defense Civilian Payroll System (DCPS).

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For E&DL, settlements and judgments, and FECA, DHP components either lacked policies and procedures to gather appropriate information to determine whether liabilities exist which should be reported or an appropriate assessment had not been performed to determine the reporting responsibility between DHP components and each respective Military Department

Effect: The DHP is unable to determine whether its liabilities, net costs, and changes in net position were complete and fairly stated in accordance with GAAP.

In situations where Military Departments pay for amounts on behalf of respective SMAs, there is risk of a potential augmentation of the DHP appropriation and violation of the Antideficiency Act.

Recommendations: Kearney recommends that the DHP:

1. Conduct a comprehensive analysis of business processes that give rise to liabilities, including unrecorded AP at the end of an accounting period, to determine whether there are unrecorded liabilities and expenses.
2. Analyze, evaluate, and update, as appropriate, policies and procedures to require the execution of internal control activities for the complete and accurate recording of liabilities, including AP and any estimates needed for goods and services received but not recorded.
3. Document estimate methodology for any liability estimates developed by the DHP and its components. The DHP should also implement internal control activities for estimate development and monitoring of the accuracy of the estimate.
4. Coordinate with applicable system owners, as appropriate, to obtain transaction-level detail for the civilian payroll unfunded leave liability pertinent to its reporting entity.
5. Collaborate with the Office of General Counsel (OGC); determine and document the legislative basis by which the Military Departments pay for E&DL, settlements and judgments, and FECA on behalf of SMA components, as applicable; and evaluate whether amounts are being charged to the correct appropriation. If any amounts are being charged to an incorrect appropriation, the DHP should evaluate the purpose statute and related concepts regarding augmentation of an appropriation and report any Antideficiency Act violations in accordance with applicable reporting requirements.

XIII. Information Systems (*New Condition*)

Background: The DHP operates in a complex information system environment to execute its mission and record transactions timely and accurately using several accounting systems and a mixture of health IT and non-medical systems. This includes third-party systems owned and operated by organizations outside of the DHP that affect the Enterprise's business processes and financial statements.

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Condition: The DHP has control deficiencies in the design, implementation, and operating effectiveness of internal controls related to financially significant systems which could have a material effect on the financial statements. Internal control deficiencies exist in 21 financially-significant systems, including six GL and financial reporting systems, four health IT systems, and other key feeder systems and environments. The following is a summary of critical deficiencies:

- Security Management
  - Inconsistent IT policies, procedures, and practices across the DHP
  - Responsibilities for controls not clearly defined and communicated throughout all components and levels of the agency
  - Unavailable or outdated system security plans and authorizations to operate for key financial management systems and supporting applications
- Access controls
  - Incomplete, inconsistent, or not fully implemented policies and procedures for managing and monitoring access to key financial management applications and third-party systems
  - Incomplete and/or inconsistent implementation of user account recertifications to verify the continued propriety of access
  - Incomplete and/or inconsistent logging and monitoring of activity for key financial management systems
- Segregation of Duties
  - Incomplete or not fully implemented policies and procedures for the proper segregation of duties within applications, databases, and operating systems
- Configuration Management
  - Lack of clear, concise IT security requirements for in-house-developed and acquired systems
  - Inability to produce detailed user listings to support periodic recertification of privileged and non-privileged user accounts
  - Inability to produce application-level audit logs related to account management and configuration management
  - Incomplete and inaccurately documented baseline configuration inventory of hardware, software, and firmware
  - Incomplete, inconsistent, or unmaintained requirements and documentation of configuration changes
- Service Organization Management
  - Incomplete, inconsistent, or not fully implemented policies and procedures for monitoring service organizations

For two systems (i.e., one core GL system and one health IT system), the DHP, with its service organizations, could not support audit procedures over internal control design and operating effectiveness which we deemed necessary to form conclusions over the respective information system control environment.

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Cause: The deficiencies result from a multitude of causal factors, with the most pervasive ones being inconsistent governance and oversight from DHP IT leadership over the component reporting entities and service organizations, lack of consistent IT policies and procedures, system limitations that prevent or hinder the implementation of effective controls, inconsistent or inadequate control design and/or implementation, and limited resources.

DHP service organizations for two systems declined to support audit procedures as a result of ongoing System and Organization Controls (SOC) examinations at the time of the financial statement audit.

Effect: Without sufficient controls throughout the information system environment, users may intentionally or unintentionally abuse computer resources, process unauthorized program changes or transactions, or perform other actions that jeopardize the confidentiality, integrity, or availability of systems and data.

For two systems, the DHP was unable to support audit procedures to obtain a complete understanding of information system controls, as well as the operating effectiveness of those controls, which would be necessary to plan and perform the audit in a timely manner. The limitation over our audit procedures over the GL system extended to the design, implementation, and operating effectiveness of key information system controls over financial reporting, including JV entry, GL posting logic, and feeder system interfaces. The limitation over our audit procedures over the health IT system extended to the design, implementation, and operating effectiveness of key information system controls, including enterprise-level access controls. These controls for both systems are essential to the DHP's controls over financial reporting and represent a significant risk if ineffective.

Recommendations: Kearney recommends that the DHP:

1. Strengthen overall IT governance by providing guidance and oversight to the components, MTFs, and service organizations on the assignment of responsibilities for the consistent implementation of internal controls.
2. Establish and communicate IT policies and procedures to the components, MTFs, and service organizations.
3. Focus on high-priority remediation activities to strengthen the maturity of the internal control environment.
4. Consider existing system limitations in the development and implementation of new and replacement systems to improve the overall control environment and keep existing limitations from being perpetuated going forward.

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANT AGREEMENTS

To the Assistant Secretary of Defense for Health Affairs and Inspector General of the Department of Defense

We were engaged to audit, in accordance with the auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*, the financial statements of the Defense Health Program (DHP) as of and for the year ended September 30, 2018, and we have issued our report thereon dated November 9, 2018. Our report disclaims an opinion on such financial statements because we were unable to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. The DHP also asserted to departures from generally accepted accounting principles.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the DHP's financial statements are free from material misstatement, we performed tests of its compliance with provisions of applicable laws, regulations, contracts, and grant agreements, noncompliance which could have a direct and material effect on the financial statements, and provisions referred to in Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions and did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the DHP. Providing an opinion on compliance with those provisions was not an objective of our audit; accordingly, we do not express such an opinion. The results of our tests, exclusive of those referred to in the FFMIA, disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 19-01 and are described in the accompanying Schedule of Findings.

The results of our tests of compliance with FFMIA disclosed that the DHP's financial management systems did not comply substantially with the Federal financial management system's requirements, applicable Federal accounting standards, or application of the United States Standard General Ledger (USSGL) at the transaction level, as described in the accompanying Schedule of Findings.

Additionally, if the scope of our work had been sufficient to enable us to express an opinion on the financial statements, other instances of noncompliance or other matters may have been identified and reported herein.

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The DHP's Response to Findings

The DHP's response to the findings identified in our engagement is described in a separate memorandum attached to this report in Section 2, *Financial Section*, of the Agency Financial Report. The DHP's response was not subjected to the auditing procedures applied in our engagement to audit the financial statements; accordingly, we do not express an opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's compliance. This report is an integral part of an engagement to perform an audit in accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01 in considering the entity's compliance. Accordingly, this communication is not suitable for any other purpose.

Kearney & Company

Alexandria, Virginia
November 9, 2018

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Schedule of Findings

Noncompliance and Other Matters

I. The Federal Managers' Financial Integrity Act of 1982 (FMFIA) (*New Condition*)

The Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, implements the requirements of the Federal Managers' Financial Integrity Act of 1982 (FMFIA). FMFIA and OMB Circular A-123 require agencies to establish a process to document, assess, and assert to the effectiveness of internal control over financial reporting.

The Defense Health Program (DHP) has not established and implemented controls in accordance with standards prescribed by the Comptroller General of the United States, as codified in the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (the Green Book), as evidenced by the material weakness in our *Report on Internal Control over Financial Reporting*.

As discussed in Section I, *Governance Structure and Entity-Level Controls*, of our *Report on Internal Control over Financial Reporting*, the audit identified the following instances of noncompliance with FMFIA and OMB Circular A-123:

- The DHP has not fully implemented processes to support the effective design and operation or evaluation of its entity-level internal controls. Due to extensive design and effectiveness failures noted, the DHP did not achieve the GAO-prescribed principles for an effective internal control system
- The DHP lacks an established organizational structure to effectively implement, direct, and oversee the assessment process across components.

II. The Federal Information Security Modernization Act of 2014 (FISMA) (*New Condition*)

The Federal Information Security Modernization Act of 2014 (FISMA) requires agencies to provide information security controls commensurate with the risk and potential harm of not having those controls in place. The National Institute of Standards and Technology (NIST) publishes standards and guidelines for Federal entities to implement for non-national security systems. Deviations from NIST standards and guidelines represent departures from FISMA requirements. During our audit, we noted several deviations from NIST standards and guidelines that contributed to an overall material weakness related to information systems, as described in Section XIII, *Information Systems*, in our *Report on Internal Control over Financial Reporting*. These deviations represent the DHP's noncompliance with FISMA. By not complying with FISMA, the DHP's security controls may adversely affect the confidentiality, integrity, and availability of information and information systems.

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III. The Federal Financial Management Improvement Act of 1996 (FFMIA) (*New Condition*)

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires that an entity's overall financial management systems environment operate, process, and report data in a meaningful manner to support business decisions. Compliance with FFMIA is achieved through substantial compliance with the following three Section 803(a) requirements:

- Federal financial management system requirements
- Applicable Federal accounting standards
- United States Standard General Ledger (USSGL) at the transaction level.

The DHP's financial management systems do not substantially comply with the requirements within FFMIA, as asserted to by management, and as discussed below.

Federal Financial Management Systems Requirements

FFMIA requires reliable financial reporting, including the availability of timely and accurate financial information, and maintaining internal control over financial reporting and financial system security. The matters described in the *Basis for Disclaimer of Opinion* section in the accompanying *Independent Auditor's Report*, as well as the material weaknesses reported in the accompanying *Report on Internal Control over Financial Reporting*, represent noncompliance with the requirement for reliable financial reporting.

FFMIA requires financial management systems owners to implement and monitor Federal information system security controls to minimize the impact to the confidentiality, integrity, and availability of the systems and data. The primary means for Federal entities to provide these controls is the implementation and monitoring of controls defined in NIST Special Publication (SP) 800-53, *Recommended Security Controls for Federal Information Systems*. The DHP deviated from recommended controls included in NIST SP 800-53, as discussed in Section XIII, *Information Systems*, in our *Report on Internal Control over Financial Reporting*. These deviations related to security management, access controls, segregation of duties, and configuration management, which represent instances of noncompliance with information security requirements.

Federal Accounting Standards

FFMIA requires that agency management systems maintain data to support reporting in accordance with generally accepted accounting principles (GAAP). As identified through our audit procedures and as noted by the DHP in Note 1, *Summary of Significant Accounting Policies*, the DHP disclosed several instances where it departed from GAAP. The DHP asserted to the following departures from GAAP:

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- Accrual accounting requirements per Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, and SFFAS No. 5, *Accounting for Liabilities of The Federal Government*
- Recognition and valuation requirements set forth in SFFAS No. 3, *Accounting for Inventory and Related Property*
- Liability requirements set forth in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, and SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*
- Recognition and valuation requirements set forth in SFFAS No. 6, *Accounting for Property, Plant, and Equipment*
- Revenue recognition requirements set forth in SFFAS No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*
- Recognition and valuation requirements set forth in SFFAS No. 8, *Supplementary Stewardship Reporting*
- Recognition and valuation requirements set forth in SFFAS No. 10, *Accounting for Internal Use Software*
- Reporting and valuation requirements set forth in SFFAS No. 29, *Heritage Assets and Stewardship Land*
- The full cost provisions of SFFAS No. 4, *Managerial Cost Accounting Standards and Concepts*, as amended by SFFAS No. 30, *Inter-Entity Cost Implementation* and SFFAS No. 55, *Amending Inter-entity Cost Provisions*
- Accounting and reporting requirements associated with restatements per SFFAS No. 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, and OMB Circular A-136, *Financial Reporting Requirements*
- Reporting requirements set forth in SFFAS No. 42, *Deferred Maintenance and Repairs: Amending Statements of Federal Financial Accounting Standards 6, 14, 29, and 32*
- Recognition and reporting requirements set forth in SFFAS No. 47, *Reporting Entity*.

USSGL at the Transaction Level

FFMIA requires that agency management systems record financial events by applying the USSGL guidance in the Treasury Financial Manual (TFM) at the transaction level. The DHP's financial management systems do not always record financial events in accordance with the requirements of the USSGL at the transaction level. The DHP has not complied with USSGL requirements in the following instances:

- The DHP uses core accounting systems, which, for certain components, are not fully compliant with the USSGL. Specifically, such accounting systems do not:
  - Accumulate or transmit complete and accurate attribute data to support financial reporting requirements
  - Possess General Ledger Account Codes (GLAC) which match standard USSGL accounts correctly in all instances and require a crosswalk for reporting

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- The DHP did not accumulate expenses for stockpile material in accordance with USSGL requirements. The DHP recorded stockpile material as operating expenses within the core accounting system. For additional details, see Section XI, *Operating Materials and Supplies (OM&S) and Stockpile Material*, in our *Report on Internal Control over Financial Reporting*
- Property, Plant, and Equipment (PP&E) capital expenditures were recorded as operating expenses within the core accounting system. The DHP was unable to separately identify capitalized expenses from non-capital expenses to appropriately record internal use software (IUS) expenditures in accordance with USSGL requirements. For additional details, see Section X, *IUS and IUS In-Development*, in our *Report on Internal Control over Financial Reporting*
- The DHP did not consistently track and accumulate revenue and accounts receivable data to post GL transactions consistent with USSGL requirements. The DHP had revenue and accounts receivable transactions recorded in subsidiary systems which were not recorded in the GL. For additional details, see Section VI, *Medical Revenue and Associated Receivables*, in our *Report on Internal Control over Financial Reporting*
- The DHP's financial statements included summarized amounts that could not be supported at the transaction level for:
  - Expenditure and obligation transactions for OM&S that were recorded in subsidiary systems but could not be reconciled to amounts recorded in the accounting system
  - Revenue transactions associated with patient care provided for which no underlying transactional activity is maintained.

IV. The Debt Collection Improvement Act of 1996 (DCIA) (*New Condition*)

The Debt Collection Improvement Act of 1996 (DCIA), as amended by the Digital Accountability and Transparency Act of 2014, requires that any non-tax debt or claim owed to the U.S. Government that is over 120 days delinquent, is required to be reported to the Department of the Treasury (Treasury) for purposes of administrative offset. The DHP did not transfer all outstanding eligible debt in accordance with DCIA requirements. The DHP had debts that were not referred to Treasury despite exceeding the delinquency threshold of 120 days. Outstanding debt not referred to Treasury exceeded 500 days delinquent on average.

Response to Independent Auditor's Report

Financial Operations
(J-8)

DEFENSE HEALTH AGENCY
7700 ARLINGTON BOULEVARD, SUITE 5101
FALLS CHURCH, VIRGINIA 22042-5101

MEMORANDUM FOR KEARNEY AND COMPANY AUDITORS

SUBJECT: Management's Response to Independent Auditor's Report for Fiscal Year 2018

We appreciate the opportunity to comment on the Independent Auditor's Report on the Defense Health Programs Enterprise (DHP Enterprise) Fiscal Year (FY) 2018 consolidated financial statements, and the Reports on the Internal Control over Financial Reporting, and Compliance with Laws, Regulations, Contracts, and Grant Agreements. Although the FY 2018 audit resulted in a Disclaimer of Opinion, DHP Enterprise recognizes this was its first full scope audit and identified areas of opportunity for improvement throughout the organization.

We also acknowledge the material weaknesses identified in the Report on Internal Control over Financial Reporting and the findings identified in the Compliance with Laws, Regulations, Contracts, and Grant Agreements. We will continue to focus on efforts that implement risk management methodologies, modernize financial management systems, evaluate internal controls at the component level, and improve the accuracy of financial reporting. We will begin initiating root cause analyses and appropriate corrective action plans necessary to resolve financial reporting deficiencies. We will assess opportunities to enhance design and operating effectiveness of key controls as required. We are committed to timely implementation of enhancements and required change management processes.

DHP Enterprise has an obligation to the American taxpayer to be good stewards of its resources and to support sound business processes. DHP Enterprise understands providing reliable Information Technology systems and effective management internal controls are key to honoring these commitments. Thus, DHP Enterprise reiterates its continued focus on a strong internal control environment and highest standards of integrity and transparency in reporting its financial performance and looks forward to implementing recommendations to enhance existing controls and procedures related to DHP Enterprise's financial management processes.

Signed

Jeffrey V. Zottola
Deputy Assistant Director (J-8)
Chief Financial Officer

Principal Financial Statements and Notes

These financial statements have been prepared to report the financial position, results of operations, net position, and budgetary resources of DHP Enterprise, as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, other appropriate legislation, and in accordance with the form and content provided by OMB Circular A-136, *Financial Reporting Requirements*.

The responsibility for the integrity of the financial information contained within these statements rests with DHP Enterprise management. Kearney & Company, P.C. (Kearney) was the independent public accountant engaged to audit these financial statements. The Independent Auditor's Report accompanies the principal financial statements and notes.

A brief description of the nature of each required financial statement and the related notes are listed below.

Consolidated Balance Sheet

The Balance Sheet presents amounts of current and future economic benefits owned or managed by DHP Enterprise (assets), amounts owed by DHP Enterprise (liabilities), and residual amounts which constitute the difference (net position).

Consolidated Statement of Net Cost

The Statement of Net Cost presents the net cost of operations for the four program areas established in the DHP Enterprise's strategic plan. It also presents reimbursable costs related to services provided to other federal agencies and incurred costs that are not part of DHP Enterprise's core mission.

Consolidated Statement of Changes in Net Position

The Statement of Changes in Net Position reports the change in net position during the period. Net position is affected by changes to its two components, unexpended appropriations and cumulative results of operations.

Combined Statement of Budgetary Resources

The Statement of Budgetary Resources provides information about DHP Enterprise's budgetary resources, status of budgetary resources, and net outlays. The DHP Enterprise's budgetary resources consist of appropriations and spending authority from offsetting collections. Budgetary resources provide DHP Enterprise its authority to incur financial obligations that will ultimately result in outlays.

Notes to Financial Statements

Notes to the financial statements communicate information essential for fair presentation of the financial statements that is not displayed on the face of the financial statement.

Department of Defense

Defense Health Program Enterprise

Consolidated Balance Sheet as of September 30, 2018

(dollars in thousands)

		Unaudited FY 2018
ASSETS (Note 2)		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	$	20,533,206
Accounts Receivable (Note 4)		463,605
Total Intragovernmental Assets	$	20,996,811
Accounts Receivable, Net (Note 4)	$	701,933
Inventory and Related Property (Note 5)		32,461
General Property, Plant, and Equipment, Net (Note 6)		3,725,741
Other Assets (Note 7)		31,542
TOTAL ASSETS	**$**	**25,488,488**
STEWARDSHIP PROPERTY, PLANT AND EQUIPMENT (Note 1)		
LIABILITIES (Note 8)		
Intragovernmental:		
Accounts Payable (Note 9)	$	324,986
Other Liabilities (Note 10)		98,933
Total Intragovernmental Liabilities	$	423,919
Accounts Payable (Note 9)	$	676,201
Military Retirement and Other Federal Employment Benefits (Note 11)		251,338,190
Accrued Unfunded Annual Leave		335,237
Accrued Funded Payroll and Benefits		215,602
Environmental and Disposal Liabilities (Note 12)		15,566
Other Liabilities (Note 10)		34,118
TOTAL LIABILITIES	**$**	**253,038,833**
COMMITMENTS AND CONTINGENCIES (Notes 13 and 14)		
NET POSITION		
Unexpended Appropriations	$	19,243,749
Cumulative Results of Operations		(246,794,094)
TOTAL NET POSITION	**$**	**(227,550,345)**
TOTAL LIABILITIES AND NET POSITION	**$**	**25,488,488**

The accompanying notes are an integral part of the statements.

Department of Defense

Defense Health Program Enterprise

Consolidated Statement of Net Cost for the year ended September 30, 2018

(dollars in thousands)

		Unaudited **FY 2018**
Program Costs		
Operations, Readiness and Support		
Gross Costs	$	31,968,999
Less: Earned Revenue		(3,635,239)
Net Program Cost	$	28,333,760
Procurement		
Gross Cost	$	463,102
Less: Earned Revenue		(6,494)
Net Program Cost	$	456,608
Research, Development, Test and Evaluation		
Gross Cost	$	1,018,595
Less: Earned Revenue		(43,339)
Net Program Cost	$	975,256
Family Housing and Military Construction		
Gross Cost	$	(243,802)
Net Program Cost	$	(243,802)
Total Gross Costs	**$**	**33,206,894**
Less: Total Earned Revenue		(3,685,072)
Net Program Cost	**$**	**29,521,822**
(Gain) from Actuarial Assumption Changes (Note 11)		(279,113)
NET COST OF OPERATIONS	**$**	**29,242,709**

The accompanying notes are an integral part of the statements.

Department of Defense

Defense Health Program Enterprise

Consolidated Statement of Changes in Net Position for the year ended September 30, 2018

(dollars in thousands)

		Unaudited FY 2018
UNEXPENDED APPROPRIATIONS		
Beginning Balances	$	18,951,904
Budgetary Financing Sources:		
Appropriations received	$	35,634,199
Appropriations transferred out		(1,191,372)
Other adjustments to Appropriations		(1,165,588)
Appropriations used		(32,985,394)
Total Budgetary Financing Sources	**$**	**291,845**
TOTAL UNEXPENDED APPROPRIATIONS	**$**	**19,243,749**
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	$	(250,231,870)
Budgetary Financing Sources:		
Appropriations used	$	32,985,394
Non-exchange revenue		7,771
Other Adjustments		(33,287)
Other Financing Sources:		
Transfers out without reimbursement		(572,060)
Imputed financing from costs absorbed by others		311,523
Other Adjustments		(18,856)
Total Financing Sources	**$**	**32,680,485**
Net Cost of Operations	**$**	**29,242,709**
Net Change	**$**	**3,437,776**
TOTAL CUMULATIVE RESULTS OF OPERATIONS	**$**	**(246,794,094)**
TOTAL NET POSITION	**$**	**(227,550,345)**

The accompanying notes are an integral part of the statements.

Department of Defense

Defense Health Program Enterprise

Combined Statement of Budgetary Resources for the year ended September 30, 2018

(dollars in thousands)

		Unaudited FY 2018
BUDGETARY RESOURCES (Note 15)		
Unobligated balance from prior year budget authority, net (discretionary and mandatory)	$	5,752,610
Appropriations (discretionary and mandatory)		34,819,410
Spending Authority from offsetting collections (discretionary and mandatory)		3,529,955
TOTAL BUGETARY RESOURCES	**$**	**44,101,975**
STATUS OF BUDGETARY RESOURCES		
Total New obligations and upward adjustments	$	38,799,770
Unobligated balance, end of year:		
Apportioned, unexpired accounts		3,357,330
Exempt from apportionment, unexpired accounts		122,809
Unapportioned, unexpired accounts		4,799
Unexpired unobligated balance, end of year	$	3,484,938
Expired unobligated balance, end of year		1,817,267
Total Unobligated balance, end of year	$	5,302,205
TOTAL STATUS OF BUDGETARY RESOURCES	**$**	**44,101,975**
OUTLAYS, NET		
Outlays, net (discretionary and mandatory)	$	32,929,101
Distributed offsetting receipts		(7,811)
AGENCY OUTLAYS, NET	**$**	**32,921,290**

The accompanying notes are an integral part of the statements.

Notes to the Financial Statements

Note 1. Summary of Significant Accounting Policies

1. A. Reporting Entity Mission and Overall Structure

In 2011, the Deputy Secretary of Defense's Task Force on Reform of the Military Health System led to the creation of the Defense Health Agency (DHA), a Combat Support Agency (CSA) and a component of the Defense Health Program. In 2013, the DoD issued a directive in accordance with the Deputy Secretary of Defense memorandum formally establishing DHA as part of the DHP Enterprise, which achieved full operating capability by 2015. DHP Enterprise began preparing for the management and administration of MTFs in response to the FY 2017 NDAA. The DHP Enterprise receives its appropriation from Congress, apportioned by the Office of Management and Budget (OMB) to the Office of the Undersecretary of Defense (Comptroller), who allots these funds to the Assistant Secretary of Defense for Health Affairs (ASD(HA)). The ASD(HA) issues Funding Authorization Documents (FADs) to fund the 7 components that exist within DHP Enterprise. These 7 component entities collectively support DHP Enterprise's mission. With this appropriation, DHP Enterprise strives to promote a medically ready force by supporting a better, stronger, and more agile MHS, providing health care support for the full range of military operations, and sustaining the health of all those entrusted to its care. The DHP Enterprise's mission is to support the delivery of integrated, affordable, and high-quality health services to its beneficiaries and to drive greater global integration.

Based on DoD Directive 5136.01, the ASD(HA) exercises authority, direction, and control over DHP Enterprise and directs the use of its appropriations. For purposes of these consolidated and combined financial statements, the following 7 components comprise the DHP Enterprise financial statement reporting entity:

U.S. Army Medical Command (Army MEDCOM): Army MEDCOM provides sustained health services and research to enable readiness while caring for the soldiers and their families.

The Navy Bureau of Medicine and Surgery (Navy BUMED): Navy BUMED is a global health-care network that provides health-care support to the U.S. Navy, Marine Corps, their families, and veterans at medical treatment facilities, hospitals, clinics, hospital ships, and research units around the world.

U.S. Air Force Medical Service (AFMS): AFMS supports benefit execution and readiness to provide healthy/fit force, resilient families, and trained medics.

Defense Health Agency (DHA) Financial Operations Division (FOD): The DHA FOD distributes funding for DHA headquarters activities.

Uniformed Services University of the Health Sciences (USUHS): USUHS educates, trains, and prepares uniformed services health professionals, scientists, and leaders to support the Military and Public Health Systems, the National Security and National Defense Strategies of the United States, and the readiness of Uniformed Services.

National Capital Region Medical Directorate (NCR MD): The NCR MD supports the delivery of integrated, affordable, and high-quality health services and is responsible for driving greater integration of clinical and business processes across the National Capital Region.

DHA Contract Resource Management Office (CRM): The DHA CRM provides the following support: financial and reporting for TRICARE's centrally funded private-sector care; budget execution and component financial statements and notes preparation; and reimbursements for private-sector health-care providers for services rendered to TRICARE beneficiaries.

1. B. Basis of Accounting and Presentation

Basis of Accounting and Presentation: The DHP Enterprise's fiscal year ends September 30. These financial statements have been prepared to report the financial position, results of operations, net position, and budgetary resources of the DHP Enterprise, as required by the Chief Financial Officers (CFO) Act of 1990, expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the DHP Enterprise in accordance with, and to the extent possible, U.S. GAAP promulgated by the FASAB; OMB Circular A-136, *Financial Reporting Requirements*; and the DoD's *Financial Management Regulation (FMR).*

The DHP Enterprise is presenting full financial statements for the first time in FY 2018. As a result, the DHP Enterprise financial statements only presents current year results of its operations, the financial position, the changes in the financial position, and the combined budgetary resources.

The accompanying financial statements account for all resources for which the DHP Enterprise is responsible unless otherwise noted. These financial statements, where possible, reflect both accrual and budgetary accounting transactions. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to the receipt or payment of cash. Budgetary accounting is designed to recognize the obligation of funds according to legal requirements, which in many cases is made prior to the occurrence of an accrual-based transaction. Budgetary accounting is essential for compliance with legal constraints and controls over the use of federal funds.

However, the DHP Enterprise is unable to fully implement all elements of U.S. GAAP as promulgated by FASAB and the form and content requirements for federal government entities specified by OMB in Circular A-136, *Financial Reporting Requirements*, due to limitations of financial and nonfinancial management processes and systems of certain component entities that support the financial statements. The DHP Enterprise derives reported values and information for major asset and liability categories largely from nonfinancial systems, such as logistical systems.

The DHP Enterprise's components' financial management systems used by DHP Enterprise are unable to meet all full accrual accounting requirements as many of their components' financial and nonfinancial feeder systems and processes were designed and implemented prior to the issuance of U.S. GAAP. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by U.S. GAAP. These systems were designed to support reporting requirements for maintaining accountability over assets, reporting the status of federal appropriations, and recording information on a budgetary basis, rather than preparing financial statements in accordance with U.S. GAAP. The DHP Enterprise continues to implement process and system improvements addressing these limitations.

Elimination of Intra-Entity Transactions and Balances: Accounting standards require an entity to eliminate intra-entity activity and balances from consolidated financial statements in order to prevent overstatement for business with itself. Transactions and balances within a reporting entity (intra-entity) have been eliminated from the *Consolidated Balance Sheet, Consolidated Statement of Net Cost,* and the *Consolidated Statement of Changes in Net Position*. The *Combined Statement of Budgetary Resources* is presented on a combined basis; therefore, intra-entity transactions and balances have not been eliminated from this statement.

***Entity and Non-Entity*:** The DHP Enterprise reports both entity and non-entity assets. Entity assets are assets that the reporting entity has authority to use in its operations. Management may have authority to decide how funds are used or it may be legally obligated to use the funds a certain way. Non-entity assets are not available for use in DHP Enterprise's normal operations. The DHP Enterprise maintains stewardship accountability and reporting responsibilities for non-entity assets and will forward these non-entity assets to the Treasury or other federal agencies in the future. DHP Enterprise records a corresponding liability for these accounts receivable, net.

***Intragovernmental and Governmental Activities*: **Statement of Federal Financial Accounting Standards (SFFAS) 1, *Accounting for Selected Assets and Liabilities*, defines Intragovernmental and Governmental assets and liabilities. Intragovernmental assets and liabilities arise from transactions among federal entities. Intragovernmental assets are claims other federal entities owe to DHP Enterprise. Intragovernmental liabilities are claims DHP Enterprise owes to other federal entities.

Whereas governmental assets and liabilities arise from transactions of the federal government or an entity of the federal government with public entities, sometimes referred to as nonfederal entities. The term public entities encompasses domestic and foreign persons and organizations outside the U.S. Government. Governmental assets are claims of DHP Enterprise against public entities. Governmental liabilities are amounts that DHP Enterprise owes to public entities.

Uses of Estimates*:* The preparation of financial statements requires DHP Enterprise to make estimates and assumptions that affect these financial statements. Actual results may differ from these estimates.

Discretionary and Mandatory Spending: The DHP enterprise has both discretionary and mandatory spending. Discretionary spending is spending provided through an appropriations act(s). Mandatory spending is spending controlled by existing laws other than an appropriations act(s).

Classified Activities: SFFAS 56, *Classified Activities*, allows for certain presentations and disclosures to be modified, if needed, to prevent the disclosure of classified information. As such, information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not discernible.

1. C. Departures from U.S. GAAP

Financial management systems and operations continue to be refined as DHP Enterprise strives to record and report its financial activity in accordance with U.S. GAAP. The DHP Enterprise is determining the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with U.S. GAAP. One such action is the current revision of its accounting systems to record transactions based on the U.S. Standard General Ledger (USSGL). The DHP Enterprise has identified the following departures from U.S. GAAP, a number of which are pervasive problems within DoD that may not be remediated at the DHP Enterprise level.

Definition of Reporting Entity: The DHP Enterprise has not completed an appropriate assessment in accordance with SFFAS No. 47, *Reporting Entity*, in order to be able to properly define its financial reporting entity and ensure completeness of its financial statements and related disclosures, including beginning balances, at the Enterprise or component level. The DHP Enterprise has identified component reporting entities based on the reporting limits of the DHP appropriation, but a complete assessment of potential consolidation entities and disclosure entities for which the DHP Enterprise and its components are accountable has not been completed.

Fund Balance with Treasury (Note 1.H. and Note 3): The DHP Enterprise was not able to identify its undistributed collections and disbursements in a timely manner because the DHP Enterprise shares a Treasury Index (TI)-97 with Other Defense Organizations for Treasury reporting. In addition, the DHP Enterprise was not able to record and report transactions in suspense accounts since suspense balances are not included in FBWT balances. As a result, the DHP Enterprise is unable to explain discrepancies between its fund balance with treasury recorded in its general ledger accounts and the balance in the Treasury's accounts in accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities.*

Accounts Receivable, Net and Revenue Recognition (Notes 1.E. and 1.J., and Note 4): The DHP Enterprise did not have compliant processes in place to account for accounts receivable and the related revenue balances in accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities,* and SFFAS 7, *Accounting for Revenue and Other Financing Sources*.

The DHP Enterprise recorded accounts receivable and associated revenue upon the receipt of cash, instead of when earned. Additionally, the DHP Enterprise does not have an adequate process in place to accrue for pharmacy credits which it is owed but has not yet received.

The DHP Enterprise did not have a formal policy and procedures in place to estimate the allowance for uncollectible accounts receivable in accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities.*

Inventory and Related Property, Net (Note 1.K. and Note 5): The DHP Enterprise was not able to properly record and report inventory and other related property because its systems were not currently configured to support the management and valuation of all classes of inventory and related property in accordance with SFFAS 3*, Accounting for Inventory and Related Property.*

In addition, inventory and related property beginning balances have not been established using deemed cost as permitted by SFFAS 48, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials.*

General Property, Plant, and Equipment, Net (Note 1.L. and Note 6): Supportable general property, plant, and equipment, net beginning balances have not been established for facilities, equipment or internal use software using the alternative valuation methods permitted by SFFAS 50, *Establishing Opening Balances for General Property, Plant, and Equipment*.

The DHP Enterprise did not have compliant processes in place to account for general property, plant, and equipment, net, at historical cost, in accordance with SFFAS 6, *Accounting for Property, Plant and Equipment* and SFFAS 10, *Accounting for Internal Use Software*.

The DHP Enterprise has real property that meets both the reporting requirements of SFFAS and should be included on its balance sheet, however, portions of real property are excluded due to formal guidance from OUSD-C.

The DHP Enterprise did not have compliant processes in place to account for impairment of facilities and equipment in accordance with SFFAS 44, *Accounting for Impairment of General Property, Plant, and Equipment Remaining in Use.*

Leases (Note 1.L., Notes 6 and 13): The DHP Enterprise did not have compliant processes in place to account for capital and operating leases in accordance with SFFAS 5, *Accounting for Liabilities of the Federal Government*, SFFAS 6, *Accounting for Property, Plant and Equipment,* and SFFAS 10, *Accounting for Internal Use Software*.

***Stewardship Property, Plant, and Equipment (Note 1.N.)*:** The DHP Enterprise did not have compliant processes for stewardship property, plant, and equipment which includes heritage assets in order to meet the disclosure requirements of SFFAS 29, *Heritage Assets and Stewardship Land.*

Accounts Payable and Expenses (Note 1.O. and Note 9): The DHP Enterprise did not have compliant processes in place to account for accounts payable, accruals, and the related expenses in accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities,* and SFFAS 5, *Accounting for Liabilities of the Federal Government*.

Accrued Unfunded Annual Leave (Note 1.Q. and Note 8): Due to system limitations, the DHP Enterprise was not able to fully recognize all of its accrued leave liability in accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities.*

Federal Employee's Compensation Act (FECA) Liabilities (Note 1.O. and Note 11): The DHP Enterprise did not report the FECA actuarial liabilities/expenses and chargeback billings in accordance with SFFAS 5, *Accounting for Liabilities of the Federal Government.*

Environmental and Disposal Liabilities (Note 1.O. and Note 12): The DHP Enterprise did not have compliant processes in place to account for cleanup cost associated with general property, plant, and equipment in accordance with SFFAS 5, *Accounting for Liabilities of the Federal Government;* SFFAS 6, *Accounting for Property, Plant and Equipment;* and *Federal Financial Accounting and Auditing Technical Release 2, Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government.*

Commitments and Contingencies (Note 1.R. and Note 14): The DHP Enterprise did not have compliant processes in place to account for contingent legal liability arises from pending or threatened litigation and all contracts that contained clauses, such as price escalation, awarded fee payments, and/or dispute resolution due to the limited capabilities of the automated system processes to capture potential liabilities in accordance with SFFAS 5, *Accounting for Liabilities of The Federal Government a*nd SFFAS 12, *Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government.* Further, the DHP Enterprise does not have compliant processes in place to report an estimate of obligations related to canceled appropriations and amounts of contractual arrangements that may require future financial obligations.

Additionally, the DHP Enterprise did not have compliant processes in place to account for contingent liabilities arising from medical malpractice claims, claims brought under the Military Claims Act, and other settlements and judgments against the components of DHP Enterprise, in accordance with SFFAS 5, *as amended by SFFAS 12, Recognition of Contingent Liabilities Arising from Litigation.*

Consolidated Statement of Net Cost (Note 1.U. and Note 16): The DHP Enterprise did not have compliant processes in place to ensure its Consolidated Statement of Net Cost was presented in accordance with SFFAS 4, *Managerial Cost Accounting Concepts and Standards*, and SFFAS 55, *Amending Inter-Entity Cost Provisions*.

Intra-Entity Activity: The DHP Enterprise did not have compliant processes in place to account for intragovernmental transactions by customer in accordance with SFFAS 4, *Managerial Cost Accounting Concepts and Standards,* SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, and SFFAS 55, *Amending Inter-entity Cost Provisions,* which require that an entity eliminates intra-entity activity and balances from consolidated financial statements in order to prevent overstatement for business with itself.

1. D. Appropriations and Funds

Appropriations: The DHP Enterprise receives general fund appropriations. General funds are used for financial transactions funded by congressional appropriations, including personnel, operation and maintenance, research and development, procurement, and military construction. The DHP Enterprise uses these appropriations and funds to execute its missions and subsequently report on resource usage.

Deposit Funds: The DHP Enterprise maintains immaterial deposit funds. These funds are used to record amounts held temporarily until paid to the appropriate government or public entity. They are not the DHP Enterprise funds and as such, are not available for the DHP Enterprise operations. The DHP Enterprise is acting as an agent or a custodian for funds awaiting distribution.

1. E. Revenue and Other Financing Sources

Exchange and Non-exchange Revenue: The DHP Enterprise classifies revenue as either exchange revenue or non-exchange revenue. Exchange revenue is derived from transactions in which the DHP Enterprise provides goods and services to another party for a price; both the federal government and the other party receive value. Exchange revenue is presented on the *Consolidated Statement of Net Cost* and serves to offset the costs of goods and services. Non-exchange revenue is derived from the government’s sovereign right to demand payment, such as specifically identifiable, legally enforceable claims. Non-exchange revenue is considered to reduce the cost of the DHP Enterprise operations and is therefore reported on the *Consolidated Statement of Changes in Net Position* as a financing source.

Appropriations Used: Most of the DHP Enterprise’s operating funds are provided by congressional appropriations of budgetary authority. The DHP Enterprise receives appropriations on annual, multiple fiscal year, and no-year bases. Upon expiration of an annual or multiple fiscal year appropriation, the obligated and unobligated balances retain their fiscal identity, and are maintained separately within an expired account. The unobligated balances can be used to make legitimate adjustments to prior year obligations, but are otherwise not available for new obligations. Annual and multiple fiscal year appropriations are canceled at the end of the fifth fiscal year after expiration. No-year appropriations do not expire. Appropriation of budget authority is recognized as used when costs are incurred, for example, when goods and services are received, or benefits and grants are provided.

Imputed Financing Sources from Cost Absorbed by Others and Imputed Cost: In certain cases, operating costs of the DHP Enterprise are paid in full or in part by funds appropriated to other federal entities. The DHP Enterprise includes applicable imputed costs in the *Consolidated Statement of Net Cost.* In addition, *Imputed Financing Sources* from *Cost Absorbed by Others* is recognized on the *Consolidated Statement of Changes in Net Position* as other financing source (non-exchange revenue).

The DHP Enterprise has elected to begin early implementation of SFFAS 55, *Amending Inter-Entity Cost Provisions*. SFFAS 55 permits entities to no longer recognize imputed costs and corresponding imputed financing from any non-business type activities, except for personnel benefit costs and Treasury Judgement Fund settlement costs.

The U.S. has cost-sharing agreements with countries having a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. Fleet is in a port (U.S. allies). However, the DHP Enterprise does not report the consolidated support provided by U.S. allies for common defense and mutual security on the *Consolidated Statement of Net Cost* and in Note 16, *Reconciliation of Net Cost of Operations to Budget*.

Transfer In/(Out): Intragovernmental transfers may include budgetary resources or assets without reimbursement, are recorded at book value, and reported in the *Consolidated Statement of Changes in Net Position.*

Other Financing Sources: The DHP Enterprises receives congressional appropriations as financing sources that expire annually, on a multi-year basis, or do not expire.

1. F. Recognition of Expenses

The DHP Enterprise estimates expenses for major items such as payroll expenses, accounts payable, environmental liabilities, and unbilled revenue. In the case of Operating Materiel & Supplies (OM&S), operating expenses are generally recognized when OM&S items are purchased.

OM&S is considered tangible personal property to be consumed in normal operations. The DHP Enterprise OM&S encompasses pharmaceuticals, pharmaceutical medical supplies, and non-pharmaceutical medical supplies.

1. G. Transactions with Foreign Governments and International Organizations

The DHP Enterprise sells services to foreign governments and international organizations under the provision of the Arms Export Control Act of 1976. Under the provisions of the Act, DoD has the authority to sell defense articles and services to foreign governments and international organizations, generally at no profit or loss to the federal government.

1. H. Fund Balance with Treasury

The U.S. Treasury Department performs cash management activities for all Federal Government agencies. The Fund Balance with Treasury (FBwT) represents the DHP Enterprise’s right to draw funds from the Treasury for allowable expenditures. FBwT is increased by the receipt of appropriations and collections and decreased by outlays and fund transfers.

The U.S. Treasury maintains and reports fund balances at the Treasury Index appropriation level. Defense agencies, to include the DHP Enterprise, are included at the Treasury Index 97 appropriation level, an aggregate level that does not provide identification of the separate defense agencies. As a result, the U.S. Treasury does not separately report on an amount for the DHP Enterprise.

FBwT is classified as unobligated available, unobligated unavailable, or obligated. Unobligated funds, depending on budget authority, are generally available for new obligations in current operations. The unavailable balance represents funds that were appropriated in prior years which are unavailable to fund new and future obligations. The obligated-not-yet-disbursed balance represents amounts designated for payment of goods and services ordered but not yet received, or goods and services received but for which payments have not been made.

The DHP Enterprise conducts a portion of operations overseas. Congress established a special account to handle the gains and losses from foreign currency transactions for five general fund appropriations: (1) operations and maintenance; (2) military personnel; (3) military construction; (4) family housing operation and maintenance; and (5) family housing construction. The gains and losses are calculated as the variance between the exchange rate current at the date of payment and a budget rate established at the beginning of each fiscal year by OUSD-C. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation at the time of payment. The DHP Enterprise does not separately identify currency fluctuation transactions on its financial statements.

1. I. Undistributed Disbursements and Collections

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to specific obligations, payables, or receivables in the source systems and those reported by the U.S. Treasury. Supported disbursements and collections have corroborating documentation for the summary-level adjustments made to accounts payable and receivable. Unsupported disbursements and collections do not have supporting documentation for the transaction. However, both supported and unsupported adjustments may have been made to the DoD or component entity in line with DoD accounts payable and receivable trial balances prior to validating underlying transactions.

The DoD policy is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of distributed federal and nonfederal accounts payable and accounts receivable. Supported undistributed disbursements and collections are then applied to reduce accounts payable and receivable accordingly. Unsupported undistributed disbursements are recorded as disbursements in transit and reduce nonfederal accounts payable. Unsupported undistributed collections are recorded in other liabilities due to the public.

1. J. Accounts Receivable, Net

Accounts receivable are amounts due to the DHP Enterprise from other federal entities or the public. All intragovernmental amounts are considered fully collectible because claims with other federal agencies are resolved in accordance with the intragovernmental business rules; therefore, no allowance for loss provision is recognized.

An allowance for loss on public receivables must be recorded, which will provide for reducing gross receivables by the amount of the estimated loss to their net realizable value. The CRM only recognizes an allowance for uncollectible amounts from the public. The method used to calculate the percentage for bad debt allowance on the accounts receivable balances is determined by taking a 12 month average of the accounts receivable balance against the 12 month average on the write off balance per each accounts receivable category. The data from the prior 12 months is used to calculate the percentages for the allowance. The CRM has one specific accounts receivable category that follows a different percentage calculation rule, the "Suspended Pharmacy" category. Per a DHA Program Integrity directive that prevents CRM's Pharmacy contractor from pursuing collection action against Suspended Pharmacies while under investigation, CRM uses a 100% allowance methodology for calculating the debt against the accounts receivable balance. Claims with other federal agencies are resolved in accordance with the intragovernmental business rules.

The DHP Enterprise is required to transfer the collection of accounts receivable at 120 days to the U.S. Treasury Department for additional collection efforts. Accounts receivable that are transferred to the U.S. Treasury Department for collection should remain on the DHP Enterprise's books until the U.S. Treasury Department acknowledges that the debt is uncollectible. Once the U.S. Treasury acknowledges that the debt is uncollectible, the DHP Enterprise will close out the bad debt and take it off their books.

1. K. Inventory and Related Property

The DHP Enterprise inventory and related property includes stockpile materials. Stockpile materials are strategic and critical materials held due to statutory requirements for use in national defense, conservation, or national emergencies. Stockpile materials are not held with the intent of selling in the ordinary course of business. The DHP Enterprise is required to maintain various medications for the DoD in the event a medical epidemic reaches the United States.

1. L. General Property, Plant, and Equipment, Net

Capitalization Threshold: The DHP Enterprise capitalizes acquisitions of fixed assets when the acquisition costs equal or exceed $250 thousand and the fixed assets has a useful life greater than two years.

Depreciation Method:

Asset Classes	Depreciation/Amortization Method	Service Life
Buildings, Structures, and Facilities	S/L*	20, 40 or 45
Software, Internal Use Software	S/L	2-5 or 10
Equipment	S/L	5

*Straight line (S/L)

Buildings, structures, and facilities: Real property in the federal government generally includes land, land improvements, buildings, facilities, and structures. The DHP Enterprise does not own land or land improvements. However, for buildings, facilities, and structures, OUSD-C directed the DHP Enterprise to stop reporting these types of real property assets. As of September 30, 2018, the real property balance on the *Consolidated Balance Sheet* included certain facilities and structures.

Equipment: Equipment includes equipment, software purchased, and internal use software meeting the capitalization threshold and expected to be used in the DHP Enterprise's operations.

Software: The DHP Enterprise has not fully developed and executed its accounting policy and related reporting for software and internal use software.

Construction-In-Progress (CIP): In accordance with Technical Bulletin 2017-2, *Assigning Assets to Component Reporting Entities,* a policy change issued by the OUSD-C requires the DHP Enterprise components that are allocated construction funds to record CIP projects on that component's books. Completed CIP projects are then transferred to the respective Military Department property holder. The DHP Enterprise allocates and provides oversight for all its military construction. The U.S. Army Corps of Engineers, and Naval Facilities and Engineering Command, and the Air Force Civil Engineering Center are the execution agents for all DHP Enterprise CIP and related funds received.

Leases: The DHP Enterprise has not fully developed and executed its accounting policy and related reporting requirements for its lease activity. The DHP Enterprise is in the process of performing an analysis of its lease contracts, but that process has not yet been completed as of September 30, 2018.

1. M. Other Assets

Advances and Prepayments: When advances are permitted by law, legislative action, or presidential authorization, the DHP Enterprise's policy is to record advances or prepayments. As such, payments made in advance of the receipt of goods and services are reported as assets on the *Consolidated Balance Sheet*. The DHP Enterprise's policy is to expense and/or properly classify assets when the related goods and services are received.

1. N. Stewardship Property, Plant, and Equipment

Disclosures for stewardship property, plant, and equipment are required under SFFAS 29, *Heritage Assets and Stewardship Land*. DHP Enterprise has heritage assets. Heritage assets are unique for one or more of the following reasons: (1) historical or natural significance, (2) cultural, educational, or artistic importance, or (3) significant architectural characteristics. Heritage assets are generally expected to be preserved indefinitely. The DHP Enterprise operates the National Museum of Health and Medicine.

1. O. Liabilities

Liabilities represent probable and measurable amounts to be paid by the DHP Enterprise as a result of past transactions and are recognized when incurred, regardless of whether there are budgetary resources available to pay them. However, the liquidation of these liabilities will consume budgetary resources and cannot be made until available budgetary resources have been obligated. Thus, for financial reporting purposes, the liabilities are classified as liabilities covered or not covered by budgetary resources.

Covered and Uncovered Liabilities: Liabilities incurred that are covered by available budgetary resources as of the *Consolidated Balance Sheet* date are referred to as funded liabilities. Liabilities are covered by budgetary resources if they are funded by appropriations, provided that the resources are apportioned by OMB without further action by the Congress and without a contingency having to be met first. Budgetary resources include: (1) new budget authority, (2) unobligated balances of budgetary resources at the beginning of the year or net transfers of prior-year balances during the year, (3) spending authority from offsetting collections (credited to an appropriation or fund account), and (4) recoveries of unexpired budget authority through downward adjustments of prior-year obligations.

Liabilities that are not covered by available budgetary resources as of the *Consolidated Balance Sheet* date are referred to as unfunded liabilities.

Current and Noncurrent Liabilities: The DHP Enterprise segregates its other liabilities between current and noncurrent liabilities. The current liabilities represent liabilities that the DHP Enterprise expects to settle within the 12 months of the Balance Sheet date. Noncurrent liabilities represent liabilities that DHP Enterprise does not expect to be settled within the 12 months of the Balance Sheet date.

Accounts Payable: Accounts payable are amounts primarily owed for goods, services, or capitalized assets received, progress on contract performance by others, and other expenses due.

FECA Liabilities: FECA liabilities provide income and medical cost protection to covered federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (DOL), which pays valid claims against the DHP Enterprise and subsequently seeks reimbursement from DHP Enterprise for these paid claims. Therefore, the accrued FECA liability, included in Intragovernmental Other Liabilities, represents amounts due to DOL for claims paid on behalf of the DHP Enterprise. These liabilities are not covered by budgetary resources because funding has not been made available.

In addition, the DHP Enterprise recognizes an actuarial FECA liability. The actuarial FECA liability represents the liability for future workers' compensation (FWC) benefits, which includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. The liability is determined by DOL annually, as of September 30, using a method that utilizes historical benefits payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Projected annual payments were discounted to present value based on OMB's interest rate assumptions, which were interpolated to reflect the average duration in years for income payments and medical payments.

To provide more specifically for the effects of inflation on the liability for FWC benefits, wage inflation factors (cost-of-living adjustment) and medical inflation factors (consumer price index – medical) are applied to the calculation of projected future benefits. The actual rates for these factors are also used to adjust the historical payments to current-year constant dollars. These liabilities are not covered by budgetary resources because funding has not been made available.

Environmental and Disposal Liabilities: The DHP Enterprise has not fully developed and executed its accounting policy and related reporting for environmental and disposal liabilities. These liabilities are not covered by budgetary resources because funding has not been made available.

1. P. Military Retirement and Other Federal Employment Benefits

Military Retirement and Other Federal Employment Benefits provide income and medical benefits to covered military personnel and Federal civilian employees. These actuarial liabilities are not covered by budgetary resources because funding has not yet been made available.

The DHP Enterprise implemented requirements of SFFAS No. 33, *Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates,* which directs that the discount rate, underlying inflation rate, and other economic assumptions be consistent with one another. A change in the discount rate may cause other assumptions to change as well. For the September 30, 2018, financial statement valuation, the application of SFFAS No. 33 required DoD OACT to set the long-term inflation, the Consumer Price Index (CPI), the DHP actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2018 balance represents the September 30, 2018 amount that will be effective through 3rd quarter of FY 2019.

1. Q. Accrued Unfunded Annual Leave

Accrued leave includes salaries, wages, and other compensation earned by employees, but not disbursed as of September 30, 2018. Annually, as of September 30, the balances of accrued unfunded annual leave are adjusted to reflect current pay rates. Sick leave and other types of non-vested leave are expensed as taken. These liabilities are not covered by budgetary resources because funding has not yet been made available.

1. R. Commitments and Contingencies

A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. SFFAS 5, *Accounting for Liabilities of the Federal Government*, as amended by SFFAS 12, *Recognition of Contingent Liabilities Arising from Litigation,* requires contingent liabilities and related expenses to be recognized when a past event has occurred, and a future outflow or other sacrifice of resources is measurable and probable. Further, SFFAS 5, as amended, requires (1) report a contingent liability on the balance sheet when an unfavorable outcome is 'probable,' and (2) disclose a contingent liability in the notes to the financial statements when an unfavorable outcome is 'reasonably possible.' No disclosure is required if the loss from a contingent liability is considered 'remote.'

A contingent legal liability arises from pending or threatened litigation, possible claims, and assessments which could result in monetary loss to an entity. The actual monetary liability in contingent legal cases can be considered case-by-case or as an aggregate of multiple cases.

The DHP Enterprise's risk of loss and resultant contingent liabilities arising from pending or threatened litigation or claims and assessments are due to events such as medical malpractice, property or environmental damages, and contract disputes.

1. S. Net Position

Net position is the residual difference between assets and liabilities, and is comprised of Unexpended Appropriations and Cumulative Results of Operations.

Unexpended Appropriations: Unexpended appropriations represent the amounts of budgetary resources that are unobligated and have not been rescinded or withdrawn. Unexpended appropriations also represent amounts obligated for which legal liabilities for payments that have not been incurred.

Cumulative Results of Operations: Cumulative Results of Operations represent the net difference between expenses and losses, and financing sources (including appropriations, revenue, and gains), since inception. The cumulative results of operations also include transfers in and out of assets that were not reimbursed.

1. T. Treaties for Use of Foreign Bases

The DHP Enterprise has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State. Generally, the treaty terms allow the DHP Enterprise continued use of these properties until the treaties expire. The DHP Enterprise purchases capital assets overseas with appropriated funds; however, the host country retains title to the land and capital improvements. In the event treaties or other agreements are terminated, use of the foreign bases is prohibited and losses are recorded for the value of any non-retrievable capital assets. The settlement due to the U.S. or host nation is negotiated and takes into account the value of capital investments and may be offset by the cost of the environmental cleanup.

1. U. Consolidated Statement of Net Cost

The *Consolidated Statement of Net Cost* represents the net cost of programs that are supported by appropriations or other means. The intent of the *Consolidated Statement of Net Cost* is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The DHP Enterprise current processes and systems capture costs based on appropriations groups. The lower level costs for major programs are presented on the statement as required by the Government Performance and Results Modernization Act of 2010.

Effective FY 2018, the Department elected early implementation of SFFAS No. 55, *Amending Inter-entity Cost Provisions,* which rescinds SFFAS No. 30, "*Inter-Entity Cost Implementation: Amending SFFAS No. 4, Managerial Cost Accounting Standards and Concepts and Interpretation 6, Accounting for Imputed Intra-departmental Costs: An Interpretation of SFFAS No. 4."* The DoD is in the process of reviewing available data and developing a cost reporting methodology as required by the SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as amended.

1. V. Tax Status

The DHP Enterprise is not subject to federal, state, or local income taxes. Accordingly, no provision for income taxes is recorded.

Note 2. Non-Entity Assets

Non-entity assets consisted of the following as of September 30, 2018 (*dollars in thousands)*:

		Unaudited
Non-Entity Assets with the Public		
Accounts Receivable, Net	$	3,225
Total Non-Entity Assets with the Public	$	**3,225**
Total Entity Assets	$	**25,485,263**
Total Assets	**$**	**25,488,488**

The non-entity accounts receivable due from the public, restricted by nature, consists of refund receivables, interest receivables, penalties and fines, and the related allowance for loss on interest receivables. As debts are repaid, they are deposited to Treasury.

The DHP Enterprise acknowledges various departures from U.S. GAAP as discussed in Note 1.C, *Departures from U.S. GAAP.*

Note 3. Fund Balance with Treasury

Fund balance with Treasury consisted of the following as of September 30, 2018 (*dollars in thousands)*:

		Unaudited
Status of Fund Balance with Treasury		
Unobligated Balance		
Available	$	3,480,139
Unavailable		1,822,066
Obligated Balance not yet Disbursed		15,842,634
Total Status of Fund Balance with Treasury	$	**21,144,839**
Non-Fund Balance with Treasury Budgetary Accounts	$	(611,633)
Total Fund Balance with Treasury	**$**	**20,533,206**

Unobligated and obligated balances presented in this note may not equal related amounts reported on the *Combined Statement of Budgetary Resources* because unobligated and obligated balances reported on the *Combined Statement of Budgetary Resources* are supported by fund balance with Treasury and as other budgetary resources that do not affect fund balance with Treasury.

Non-Fund Balance with Treasury Budgetary Accounts reduce the Status of Fund Balance with Treasury. This amount is comprised of unfilled customer orders without advance and reimbursements and other income earned and not collected.

The DHP Enterprise acknowledges departures from U.S. GAAP related to fund balance with Treasury as discussed in Note 1.C, *Departures from U.S. GAAP.*

Note 4. Accounts Receivable, Net

Accounts receivable, net consisted of the following as of September 30, 2018 (*dollars in thousands*):

	Unaudited		
	Gross Amount Due	Allowance For Estimated Uncollectible	Accounts Receivable, Net
Accounts Receivable			
Intragovernmental Receivables	$ 463,605	N/A	$ 463,605
Receivables due from the Public	$ 844,918	$ (142,985)	$ 701,933
Total Accounts Receivable, Net	**$ 1,308,523**	**$ (142,985)**	**$ 1,165,538**

Intragovernmental receivables represent amounts due from other federal agencies. As of September 30, 2018, CRM had recorded $188,600 thousand related to the Standard Discount Program (SDP) and the Additional Discount Program (ADP). The SDP resulted from the implementation of the Federal Ceiling Program for the TRICARE Retail Pharmacy Refunds Program as required by the FY 2008 National Defense Authorization Act, Section 703. The ADP resulted from voluntary agreements between TRICARE and the pharmaceutical manufacturers providing additional discounts above the SDP.

The DHP Enterprise acknowledges departures from U.S. GAAP related to accounts receivable, net as discussed in Note 1.C, *Departures from U.S. GAAP.*

Note 5. Inventory and Related Property

Inventory and related property as of September 30, 2018 (*dollars in thousands)*:

	Unaudited
Inventory and Related Property	
Stockpile Materials Held in Reserve for Future Use	$ 32,461
Total Inventory and Related Property	**$ 32,461**

The DHP Enterprise utilizes both the actual cost and lower of cost or market valuation methods for determining its stockpile materials. Stockpile materials are restricted for use, to be used only in the event of a nationwide pandemic.

The DHP Enterprise acknowledges departures from U.S. GAAP related to inventory and related property as discussed in Note 1.C, *Departures from U.S. GAAP*.

Note 6. General Property, Plant, and Equipment, Net

General property, plant, and equipment, net consisted of the following as of September 30, 2018 (*dollars in thousands*):

				Unaudited		
		Acquisition Value		**(Accumulated Depreciation / Amortization)**		**Net Book Value**
Major Fixed Asset Classes						
Buildings, Structures, and Facilities	$	1,556	$	-	$	1,556
Software		393,919		(315)		393,604
General Equipment		1,667,477		(1,329,544)		337,933
Construction-in-Progress (CIP)		2,986,507		N/A		2,986,507
Other		19,322		(13,181)		6,141
Total General Property, Plant, and Equipment	**$**	**5,068,781**	**$**	**(1,343,040)**	**$**	**3,725,741**

The majority of general property, plant, and equipment, net owned or leased by DHP Enterprise is primarily used to provide high quality, cost effective health care services to active forces and other eligible beneficiaries. The DHP Enterprise facilities range from sophisticated tertiary care medical centers to outpatient and dental clinics and physiological training units. Dental, surgical, radiographic, and pathologic equipment is essential to providing high quality health care services that meet accepted standards of practice. The required safety standards, related laws and regulatory requirements from credentialing and health care standard setting organizations influence and affect the requirement for, cost of, and replacement and modernization of medical equipment. The DHP Enterprise also acquires and leases capital equipment for MTFs and participates in other selected health care activities such as acquiring equipment for the initial outfitting of a newly constructed, expanded, or modernized health care facility; equipment for modernization and replacement of uneconomically reparable items; equipment supporting programs such as pollution control, clinical investigation, and occupational/environmental health; and MHS information technology (IT) requirements.

MHS GENESIS is the new electronic health record system that manages military patient health information. MHS GENESIS integrates inpatient and outpatient solutions that will connect medical and dental information across the continuum of care, from point of injury to the MTF. When fully deployed, MHS GENESIS will provide a single health record for service members, veterans, and their families. The DHP Enterprise acknowledges that MHS GENESIS is not presented in the balances above based on ongoing assessment of system for accounting and valuation purpose.

The DHP Enterprise has the use of overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State. Generally, treaty terms allow DHP Enterprise continued use of these properties until the treaties expire. There are no other know restrictions on general property, plant, and equipment.

Depreciation and amortization expense totaled $72,150 thousand for the year ended, September 30, 2018. Loss on disposition of assets totaled $3,309 thousand for the year ended, September 30, 2018.

The DHP Enterprise acknowledges departures from U.S GAAP related to general property, plant, and equipment, net as discussed in Note 1.C, *Departures from U.S. GAAP.*

Note 7. Other Assets

Other assets consisted of the following as of September 30, 2018 (*dollars in thousands)*:

		Unaudited
Other Assets		
Advances and Prepayments	$	31,542
Total Other Assets	$	**31,542**

Note 8. Liabilities

Liabilities include both covered and not covered by budgetary resources and consisted of the following as of September 30, 2018 (*dollars in thousands)*:

		Unaudited
Liabilities		
Intragovernmental		
Other	$	47,132
Total Intragovernmental	$	47,132
Liabilities Due to the Public		
Accounts Payable	$	30,895
Military Retirement and Other Federal Employment Benefits		251,338,190
Accrued Unfunded Annual Leave		335,237
Environmental and Disposal Liabilities		15,566
Total Liabilities Due to the Public	$	**251,719,888**
Total Liabilities Not Covered by Budgetary Resources	$	**251,767,020**
Total Liabilities Covered by Budgetary Resources	$	**1,271,813**
Total Liabilities	$	**253,038,833**

The DHP Enterprise acknowledges departures from U.S. GAAP related to various liabilities as discussed in Note 1.C, *Departures from U.S. GAAP*.

Note 9. Accounts Payable

Accounts payable consisted of the following as of September 30, 2018 (*dollars in thousands)*:

	Unaudited Accounts Payable		Interest, Penalties, and Administrative Fees		Total	
Accounts Payable						
Intragovernmental Payables	$	324,986	$	-	$	324,986
Payables due to the Public	$	676,184	$	17	$	676,201
Total Accounts Payable	**$**	**1,001,170**	**$**	**17**	**$**	**1,001,187**

Accounts payable include amounts owed to federal and public entities for goods and services received.

The DHP Enterprise acknowledges departures from U.S. GAAP related to accounts payable as discussed in Note 1.C, *Departures from U.S. GAAP*.

Note 10. Other Liabilities

Other liabilities consisted of the following as of September 30, 2018 (*dollars in thousands*):

	Unaudited Current Liability		Noncurrent Liability		Total	
Other Liabilities						
Intragovernmental Other Liabilities						
Advances from Others	$	13,967	$	-	$	13,967
FECA Reimbursements due to DOL		19,761		26,250		46,011
Employer Contributions and Payroll Taxes Payable		34,345		-		34,345
Other Liabilities		4,514		96		4,610
Total Intragovernmental Other Liabilities	**$**	**72,587**	**$**	**26,346**	**$**	**98,933**
Due to the Public Other Liabilities						
Advances from Others	$	3,663	$	3,434	$	7,097
Employer Contributions and Payroll Taxes Payable		20,274		-		20,274
Other Liabilities		6,747		0		6,747
Total Due to the Public Other Liabilities	**$**	**30,684**	**$**	**3,434**	**$**	**34,118**
Total Other Liabilities	**$**	**103,271**	**$**	**29,780**	**$**	**133,051**

Advances from Others represent liabilities for collections received to cover future expenses or acquisition of assets.

FECA Reimbursements due to DOL provides benefit coverage for death, disability, medical, and miscellaneous costs for approved cases of on the job incidents. FECA claims are submitted to and approved by the DOL.

Employer Contributions and Payroll Taxes Payable represents the employer portion of payroll taxes and benefit contributions for health benefits, retirement, life insurance and voluntary separation incentive payments.

The DHP Enterprise acknowledges departures from U.S. GAAP related to various liabilities as discussed in Note 1.C, *Departures from U.S. GAAP*.

Note 11. Military Retirement and Other Federal Employment Benefits

Military retirement and other federal employment benefits consisted of the following as of September 30, 2018 (*dollars in thousands)*:

		Unaudited Unfunded Liabilities
Military Retirement and Other Federal Employment Benefits		
Pension and Health Benefits		
Military Pre Medicare-Eligible Retiree Health Benefits	$	249,693,998
Total Pension and Health Benefits	**$**	**249,693,998**
Other Benefits		
FECA	$	213,964
Other		1,430,228
Total Other Benefits	$	**1,644,192**
Total Military Retirement and Other Federal Employment Benefits	**$**	**251,338,190**

The actuarial liability consists of the following as of September 30, 2018 (*dollars in thousands*):		*Unaudited* Military Pre Medicare Eligible Retiree Health Benefits
Actuarial Liability		
Beginning Actuarial Liability	$	252,512,861
Expenses		
Normal Cost	$	10,135,672
Interest Cost		9,772,839
Plan Amendments		(2,678,284)
Actuarial Experiences Gains		(8,729,912)
Other factors		(1)
Total Expenses before Gains from Actuarial Assumption Changes	**$**	**8,500,314**
Actuarial Assumption Changes		
Changes in trend assumptions	$	(3,804,999)
Changes in assumptions other than trend		3,525,886
Total (Gains) from Actuarial Assumption Changes	**$**	**(279,113)**
Total Expenses	$	8,221,201
Less: Benefit Outlays		11,040,064
Total Changes in Actuarial Liability	**$**	**(2,818,863)**
Ending Actuarial Liability (Total Pension and Health Benefits)	**$**	**249,693,998**

Military Retirement and Other Federal Employment Benefits provide income and medical benefits to covered military personnel and Federal civilian employees. These actuarial liabilities are not covered by budgetary resources because funding has not yet been made available. The DoD Office of the Actuary (DoD OACT) calculates this actuarial liability at the end of each fiscal year using the current active and retired population plus assumptions about future demographic and economic conditions.

The DHP Enterprise implemented requirements of SFFAS No. 33, *Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates,* which directs that the discount rate, underlying inflation rate, and other economic assumptions be consistent with one another. A change in the discount rate may cause other assumptions to change as well. For the September 30, 2018, financial statement valuation, the application of SFFAS No. 33 required DoD OACT to set the long-term inflation, the Consumer Price Index (CPI), the DHP actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2018 balance represents the September 30, 2018 amount that will be effective through 3rd quarter of FY 2019.

Actuarial Cost Method: As prescribed by SFFAS No. 5, the valuation of the Military Retirement Health Benefits is performed using the Aggregate Entry Age Normal (AEAN) cost method. AEAN is a method whereby projected retiree medical plan costs are spread over the projected service of a new entrant cohort.

Assumptions*:* For the FY 2018 financial-statement valuation, the long-term assumptions include a 3.6% discount rate and medical trend rates that were developed using a 1.5% inflation assumption. Note that the term ’discount rate’ refers to the interest rate used to discount cash flows. The terms ‘interest rate’ and ‘discount rate’ are often used interchangeably in this context.

The change in the long-term assumptions is due to the application of SFFAS No. 33. This applicable financial statement standard is discussed further below. The standard is discussed further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on a blend of actual experience and future expectations. Because of reporting deadlines and as permitted by SFFAS No. 33, the current year actuarial liability is rolled forward from the prior year valuation results using accepted actuarial methods. This roll-forward process is applied annually. In calculating the FY 2018 “rolled-forward” actuarial liability, the following assumptions were used:

Discount Rate	3.6%	
Inflation	**1.5%**	
Medical Trend (Non-Medicare)	**FY 2017 – FY 2018**	**Ultimate Rate FY 2042**
Direct Care Inpatient	4.45%	4.00%
Direct Care Outpatient	6.00%	4.00%
Direct Care Prescription Drugs	6.00%	4.00%
Purchased Care Inpatient	1.95%	4.00%
Purchased Care Outpatient	3.30%	4.00%
Purchased Care Prescription Drugs	3.28%	4.00%
Purchased Care USFHP	3.95%	4.00%

After a 25 year select period, an ultimate trend rate is assumed for all future projection years.

The DHP Enterprise's actuarial liability decreased $2.8 billion (1.1%). This resulted from the net effect of: an increase of $8.9 billion due to expected increases (interest cost plus normal cost less benefit outlays), a decrease of $0.3 billion due to changes in key assumptions; a decrease of $2.7 billion due to plan changes; and a decrease of $8.7 billion due to actual experience being different from what was assumed (demographic and claims data).

DoD complies with SFFAS No. 33. The standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement and other postemployment benefits. SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities. SFFAS No. 33, as published on October 14, 2008, by the FASAB requires the use of a yield curve based on marketable U.S. Treasury Securities to determine the discount rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable Treasury securities.

The statement is effective for periods beginning after September 30, 2009, and applies to information provided in general purpose federal financial statements. It does not affect statutory or other special-purpose reports, such as Pension or Other Retirement Benefit reports. SFFAS No. 33 requires a minimum of five periodic rates for the yield curve input and consistency in the number of historical rates used from period to period. It permits the use of a single average discount rate if the resulting present value is not materially different from what would be obtained using the yield curve.

For the September 30, 2018 financial-statement valuation, DoD OACT determined a single equivalent discount rate of 3.6% by using a 10-year average of quarterly zero coupon Treasury spot rates. These spot rates are based on the U.S. Department of the Treasury – Office of Economic Policy's 10-year Average Yield Curve for Treasury Nominal Coupon Issues (TNC yield curve), which represents average rates from April 1, 2008 through March 31, 2018.

Other Benefits This amount is calculated by the DoD OACT and provided to the DHP Enterprise for inclusion. The amounts captured are primarily for Incurred but not Reported (IBNR) Claim Estimates of ($1,406,221) thousand plus administrative expenses of ($4,532) thousand plus adverse experience margins ($19,203) thousand, and Life Insurance Reserve amount of ($242) thousand.

The DHP Enterprise acknowledges departures from U.S. GAAP related to FECA liabilities as discussed in Note 1.C, *Departures from U.S. GAAP.*

Note 12. Environmental and Disposal Liabilities

Environmental and disposal liabilities consisted of the following as of September 30, 2018 (*dollars in thousands)*:

		Unaudited
Environmental and Disposal Liabilities due to the Public		
Environmental Disposal for Military Equipment / Weapons Programs		
Nuclear Powered Military Equipment / Spent Nuclear Fuel	$	15,497
Other Accrued Environmental Liabilities - Non-BRAC		69
Total Environmental and Disposal Liabilities due to the Public	**$**	**15,566**

Applicable laws and regulations for cleanup requirements:

(a) Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)
(b) Superfund Amendments and Reauthorization Act (SARA)
(c) Clean Water Act
(d) Safe Drinking Water Act
(e) Clean Air Act
(f) Resource Conversation and Recovery Act (RCRA)
(g) Toxic Substances Control Act (TSCA)
(h) Medical Waste Tracking Act
(i) Atomic Energy Act
(j) Nuclear Waste Policy Act
(k) Low Level Radioactive Waste Policy Amendments Act

The DHP Enterprise is required to clean up contamination from past waste disposal practices, leaks, spills, and other activity resulting in public health or environmental risk. The DHP Enterprise accomplishes this effort in coordination with regulatory agencies and, if applicable, other responsible parties and current property owners. The DHP Enterprise is also required to recognize closure and post-closure costs for its general property, plant, and equipment, and environmental corrective action costs for current operations. Each of DHP Enterprise's major reporting entities is responsible for tracking and reporting all required environmental information related to environmental restoration costs, other accrued environmental costs, disposal costs of weapon systems, and environmental costs related to BRAC actions.

The DHP Enterprise follows the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA, Public Law 96-510), Superfund Amendments and Reauthorization Act of 1986 (SARA, Public Law 99-499), Resource Conservation and Recovery Act (RCRA, Public Law 94-580) or other applicable federal or state laws to clean up contamination. The CERCLA and RCRA require DHP Enterprise to clean up contamination in coordination with regulatory agencies, current owners of property damaged by DHP Enterprise and third parties with partial responsibility for environmental restoration. Failure to comply with agreements and legal mandates puts DHP Enterprise at risk of incurring fines and penalties.

The Nuclear Waste Policy Act of 1982 (Public Law 97-425) requires owners and generators of high-level nuclear waste and spent nuclear fuel to pay their share of the cost of the program. The Low-Level Radioactive Waste Policy Amendments Act of 1985 (Public Law 99-240) provides for the safe and efficient management of low-level radioactive waste.

For DHP Enterprise the types of environmental liabilities and disposal liabilities identified as nuclear or non-nuclear. Nuclear liabilities arise from a research reactor and irradiators. Non-nuclear liability arises from medical and chemical cleanup.

The DHP Enterprise is not aware of any pending changes but the liability can change in the future due to changes in laws and regulations, changes in agreements with regulatory agencies, and advances in technology.

Accounting estimates for environmental liabilities use reasonable judgments and assumptions based on available information. Actual results may materially vary if agreements with regulatory agencies require remediation to a different degree than anticipated when calculating the estimates. Liabilities can be further affected if investigation of the environmental sites reveals contamination levels differing from estimate parameters. The DHP Enterprise tangible property, plant, and equipment contains nonfriable asbestos. At this time, the DHP Enterprise is unable to reasonably estimate the clean-up costs.

The DHP Enterprise acknowledges departures from U.S GAAP related to environmental and disposal liabilities as discussed in Note 1.C, *Departures from U.S. GAAP*.

Note 13. Operating Leases

Future payments due under operating leases consisted of the following as of September 30, 2018 *(dollars in thousands)*:

ENTITY AS LESSEE-Operating Leases	*Unaudited* Asset Category Facilities	
Future Payments Due		
Fiscal Year	**Total Future Leases Payments**	
2019	$	20,829
2020		21,662
2021		22,529
2022		23,430
2023		24,367
After 5 Years		25,341
Total Future Lease Payments Due	**$**	**138,158**

Future minimum rental payments presented above reflect lease arrangements that have been identified in fiscal year 2019 related to the Community-Based Homes Effort. As of September 30, DHP Enterprise was committed to non-cancellable operating leases covering the Community-Based Homes Effort, an initiative under the control of U.S. Army MEDCOM to allow soldiers to remain on active duty while undergoing medical treatment, and to live and perform those duties close to their homes.

The DHP Enterprise acknowledges departures from U.S. GAAP related to leases as discussed in Note 1.C., *Departures from U.S. GAAP*.

Note 14. Commitments and Contingencies

The DHP Enterprise is a party to various administrative proceedings and legal actions related to healthcare claims payments, accidents, environmental damage, equal opportunity matters, and contractual bid protests which may ultimately result in settlements or decisions adverse to the federal government. These proceedings and actions arise in the normal course of operations and their ultimate disposition is unknown.

MEDCOM is a named party to Fair Labor and Standards Act (FLSA) claims against multiple Army MTFs. These cases are generally class actions brought by law firms on behalf of MTF employees. The potential liability stems from alleged misclassification of position descriptions which allegedly led to the underpayment of certain graded employees and, suffer and permit violations which allegedly involves employees working longer than their scheduled hours. Cases are pending at Fort Campbell, Fort Sill, White Sands, Fort Jackson, Fort Stewart, Fort Detrick, Fort Bragg, and Fort Irwin. The cases filed in the locations listed are either in preliminary or active arbitration. FLSA arbitration cases can take anywhere from 10-12 years from the date of the grievance to a decision. The Army has consolidated the defense of these cases at the Army level and major commands, along with installation legal offices, are actively participating in the defense of these cases. While some degree of this liability has been deemed reasonably possible by counsel at MEDCOM, the extent of the liability is difficult to define because in some cases lawsuits are against an entire installation rather than a single MTF and the entire settlement would not require DHP Enterprise funds. The estimated range of potential loss is estimated at $80 million, however the defensive posture established by consolidation of these cases at the Army level is expected to reduce this exposure significantly.

Additionally, the DHP Enterprise is advised that there are situations where counsel was not able to express an opinion concerning the likely outcome of a case. As such, the DHP Enterprise did not make an estimate of any probable or reasonably possible loss contingencies through its respective legal counsel.

Furthermore, medical malpractice claims and settlements arising from the activities of the Navy Bureau of Medicine, Air Force Medical Service, and Army Medical Command are paid either by funds appropriated directly to the military service lines and/or the Department of Treasury’s Judgement Fund.

The DHP Enterprise cannot estimate the amount of undelivered orders for open contracts citing cancelled appropriations.

The DHP Enterprise acknowledges departures from U.S GAAP related to the commitment and contingencies as discussed in Note 1.C, *Departures from U.S. GAAP*.

Note 15. Disclosures Related to the Combined Statement of Budgetary Resources

Disclosures related to the *Statement of Budgetary Resources* consisted of the following for the year ended, September 30, 2018:

Apportionment Categories of New Obligations and Upward Adjustments: Direct and Reimbursable Obligations

Apportionment categories of new obligations and upward adjustments consists of direct and reimbursable obligations. These obligations incurred against amounts apportioned under Category A, Category B, and Exempt from Apportionment. Category A apportionments distribute budgetary resources by fiscal quarters, whereas Category B apportionments typically distribute budgetary resources by activities, projects, objects, or a combination of these categories. The DHP Enterprise does not have any exempt apportionments. The amounts of direct obligations (derived from appropriations) and reimbursable obligations (derived from spending authority from offsetting collections) and upward adjustments by apportionment category for the year ended, September 30, 2018, consisted of (*dollars in thousands*):

		Unaudited
Direct and Reimbursable Obligations		
Direct Obligations		
Category A	$	33,447,530
Category B		3,336,172
Total Direct Obligations	$	**36,783,702**
Reimbursable Obligations		
Category A	$	1,900,216
Category B		115,852
Total Reimbursable Obligations	$	**2,016,068**
Total Obligations	**$**	**38,799,770**

Undelivered Orders at End of the Year

Undelivered orders (UDOs) consist of goods and services obligated that have been ordered but not received. Unpaid UDOs represent obligations for goods and services that have not been received or paid. Whereas, paid UDOs represent obligations for goods and services that have been paid for in advance of receipt. The budgetary resources obligated for UDOs for the year ended, September 30, 2018, consisted of (*dollars in thousands*):

		Unaudited
Undelivered Orders		
Intragovernmental		
Undelivered orders – unpaid	$	4,815,357
Total Intragovernmental Undelivered Orders	**$**	**4,815,357**
With the Public		
Undelivered orders – unpaid	$	9,776,635
Undelivered orders – paid		29,304
Total Undelivered Orders with the Public	**$**	**9,805,939**
Total Undelivered Orders	**$**	**14,621,296**

Legal Arrangements Affecting the Use of Unobligated Balances

Information about legal limitations and restrictions affecting the use of the unobligated balance of budget authority is specifically stated by program and fiscal year in the applicable appropriation language or in the alternative provisions section at the end of the appropriations act.

Explanation of Differences between the *Consolidated Statement of Budgetary Resources* and the Budget of the U.S. Government

The reconciliation between the *Combined Statement of Budgetary Resources* and the Budget of the U.S. Government (Budget) is presented below. This reconciliation is as of September 30, 2017, because submission of the budget for FY 2019, which presents the execution of the FY 2017 budget, occurs after publication of these financial statements. The DHP Enterprise budget appendix can be found on the OMB website (http://www.whitehouse.gov/omb/budget) and will be available in early February 2019.

The amounts in the line '*Other Differences'* in the table below cannot be further defined because appropriation-level detail is not provided in the Budget of the U.S. Government.

Budget of the U.S. Government (dollars in millions)

Unaudited FY 2017	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
Combined Statement of Budgetary Resources	$ 43,221	$ 37,869	$ (0)	$ 32,466
Differences	(3,972)	(514)	(1,547)	(654)
Budget of the U.S. Government	**$ 39,249**	**$ 37,355**	**$ (1,547)**	**$ 31,812**

Explanation of Differences between the *Consolidated Statement of Changes in Net Position* and the *Combined Statement of Budgetary Resources*

The '*Appropriations*' line on the *Combined Statement of Budgetary Resources* does not agree with the '*Appropriations received*' line on the *Consolidated Statement of Changes in Net Position* due to: 1) differences between proprietary and budgetary accounting concepts and reporting requirements; and 2) presentation of the *Consolidated Statement of Changes in Net Position* on a consolidated basis versus presentation of *Combined Statement of Budgetary Resources* on a combined basis.

Note 16. Reconciliation of Net Cost of Operations to Budget

The reconciliation of net cost of operations to budget for the period ended September 30, 2018, is as follows *(dollars in thousands)*:

		Unaudited
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations incurred	$	38,799,770
Less: Spending authority from offsetting collections and recoveries		(5,505,904)
Obligations net of offsetting collections and recoveries	$	33,293,866
Less: Offsetting receipts		(7,811)
Net obligations	$	33,286,055
Other Resources:		
Transfers out without reimbursement		(572,060)
Imputed financing from costs absorbed by others		311,523
Other		(18,856)
Net other resources used to finance activities	$	(279,393)
Total Resources Used to Finance Activities	**$**	**33,006,662**
Resources Used to Finance Items not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders	$	(167,242)
Unfilled Customer Orders		(26,802)
Resources that fund expenses recognized in prior periods		(7,389,447)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations		7,811
Resources that finance the acquisition of assets		(162,974)
Other		590,917
Total Resources Used to Finance Items not Part of the Net Cost of Operations	**$**	**(7,147,737)**
Total Resources Used to Finance the Net Cost of Operations	**$**	**25,858,925**
Components of the Net Cost of Operations that will Not Require or Generate Resources in the current period:		
Components Requiring or Generating Resources in Future Period:		
Increase in annual leave liability	$	2,273
Increase in exchange revenue receivable from the public		(4,081)
Other		4,534,829
Total Components of Net Cost of Operations that will Require or Generate Resources in future periods	**$**	**4,533,021**
Components Not Requiring or Generating Resources:		
Depreciation and amortization	$	72,150
Revaluation of assets or liabilities		(6,543)
Other		(1,214,844)
Total Components of Net Cost of Operations that will Not Require or Generate Resources	**$**	**(1,149,237)**
Total Components of Net Cost of Operations that will Not Require or Generate Resources in the current period.	**$**	**3,383,784**
Net Cost of Operations	**$**	**29,242,709**

The *Reconciliation of Net Cost of Operations to Budget* explains how budgetary resources obligated during the period relate to the net cost of operations for DHP Enterprise.

Due to DHP Enterprise's financial system limitations, budgetary resources obligated during the period could not be reconciled to DHP Net Cost of Operations. This difference was a previously identified deficiency requiring adjustments for the schedule to reconcile.

Other Resources or Adjustments to Net Obligated Resources that Do Not Affect Net Cost of Operations, Other primarily consists of non-exchange gains and losses to revalue assets, as well as reconcile the proprietary and budgetary amounts. The absolute value of the adjustment that reconciles the balance with the *Consolidated Statement of Net Cost* for the period ended September 30, 2018, is $29,242,709 thousands.

Components Requiring or Generating Resources in Future Period, Other consist primarily of future funded expenses.

Components Not Requiring or Generating Resources, Other primarily consist of cost capitalization offsets, applied overhead, and other expenses not requiring budgetary resources.

Recognition of liabilities not covered by budgetary resources on the *Consolidated Balance Sheet* were recognized as components of net cost that require or generate resources in future periods**.**

The following *Reconciliation of Net Cost of Operations to Budget* lines are presented as combined instead of consolidated, as intra-entity budgetary transactions are not eliminated:

Obligations Incurred

Less: Spending Authority from Offsetting Collections and Recoveries

Obligations Net of Offsetting Collections and Recoveries

Less: Offsetting Receipts

Net Obligations

Undelivered Orders

Unfilled Customer Orders

Required Supplementary Stewardship Information

Non-Federal Physical Property

The DHP Enterprise operates MTFs overseas which require the use of land, buildings, and other overseas facilities. These items are obtained through various international treaties and agreements negotiated by the Department of State. In order to keep these facilities mission ready, DHP Enterprise also purchases capital assets with appropriated funds. When these treaties expire, ownership of these purchased assets and any related improvements to these MTFs revert to the host country. DHP Enterprise acknowledges that by definition this meets the definition of nonfederal physical property but does not currently track or have a process in place to report the required information. As such, DHP Enterprise acknowledges a departure from SFFAS 8, *Supplementary Stewardship Reporting*.

Research and Development

Military combat is a joint service activity, and ensuring the best quality medical care of the warfighter must also be a cross-component effort. The medical mission of DoD is to enhance the DoD and our Nation's security by providing health support for the full range of military operations and sustaining the health of all those entrusted to our care. In order to be responsive to current needs and ready for the next fight, DoD invests significant resources into research and development of medical materiel products (e.g., equipment, tools, and devices) and knowledge products (e.g., clinical practice guidelines and protocols) for the warfighter.

The DHP Enterprise leads the MHS integrated system of readiness and health to deliver the Quadruple Aim (increased readiness, better health, better care, and lower cost). Within DHP Enterprise, the Research and Development Directorate (J-9) leads the discovery, development, and delivery of enhanced pathways to military health and readiness. The DHP Enterprise J-9 research and development activities are presented in the following three major categories:

- **Basic research:** systematic study to gain knowledge of the fundamental aspects of phenomena and of observable facts without specific applications toward processes or products in mind;
- **Applied research:** systematic study to gain knowledge necessary for determining the means by which a recognized and specific need may be met;
- **Development:** systematic use of the knowledge gained from research for the production of useful materials, devices, systems, or methods, including the design and development of prototypes and processes.

The following are highlights of some of the research and development programs/projects and their accomplishments:

Basic Research

In-House Laboratory Independent Research (ILIR) Program

The ILIR Program at USUHS is designed to answer fundamental questions of importance to the military medical mission of DoD in areas such as military operational medicine and combat casualty care. The studies within the USUHS ILIR program support the essential military mission by enhancing and protecting the health, performance and fitness of service members throughout the deployment cycle. Their discoveries should lead to better strategies for enhancing and preserving memory and reasoning capabilities under battle conditions, help understand and ultimately prevent and treat neuropsychiatric illnesses such as depression and post-traumatic stress disorder (PTSD), and assist deployed troops and their families better prepare for and contend with common, significant stressors related to the deployment cycle.

What this program will accomplish:

Military Operational Medicine

- Refinement of a PTSD screening tool for use in the DoD Primary Care system
- Identification of the unique proteomic signature for the diagnosis and assessment of the neuro-immune response to traumatic brain injury (TBI)
- Identification of novel neural stem/progenitor cell pathways for therapeutic targeting in the development of neuro-regenerative therapies to treat brain injuries

Combat Casualty Care

- Bridging tissue gaps in the periphery following injury or surgery
- Guiding the regeneration of axons to neural-prosthetic interfaces following amputation and inhibiting axon extension following excision of neuromas
- Investigation of drug-induced arrhythmias to improve the safety profile of drugs used to treat pathological conditions such as cardiac hypertrophy or hypercholesterolemia

Basic Operational Medical Research Sciences Program

The Basic Operational Medical Research Sciences Program provides support for basic medical research directed toward greater knowledge and understanding of the fundamental principles of science and medicine that are relevant to the improvement of force health protection. Research in this program is designed to address areas of interest to the Secretary of Defense regarding wounded warriors, capabilities identified through the Joint Capabilities Integration and Development System, and sustainment of DoD and multi-agency priority investments in science, technology, research, and development.

What this program will accomplish:

Military Operational Medicine

- Identification and characterization of the biomechanical responses of brain tissue in animal models due to the indirect mechanism of blast waves, i.e., through the vasculature, that will guide the development of interventions for mitigating blast-induced brain injuries
- Identification of candidate targets and neurological systems for treatment and diagnostic indicators of PTSD
- Identification of physical, physiological and psychosocial factors that may differentially impact the performance of female versus male service members and gender-based susceptibility to musculoskeletal injury

Combat Casualty Care

- Understanding of associated pathophysiologic mechanisms using advanced hemostatic and resuscitation approaches in prolonged field care scenarios
- Identification of molecular and cellular mechanisms involved in abnormal bleeding due to coagulopathy of trauma that occurs following severe trauma

Applied Research

Applied Biomedical Technology Program

The Applied Biomedical Technology Program provides applied research funding to refine concepts and ideas into potential solutions for military health and performance problems, with a view toward evaluating technical feasibility. Research in the Applied Biomedical Technology Program aims to develop medical countermeasures against operational stressors, prevent musculoskeletal, neurosensory, and psychological injuries during training and operations, and to maximize health, performance and fitness of service members. Additionally, the research is focused on optimizing survival and recovery from point of injury through en route and facility care including efforts to reconstruct, rehabilitate, and provide care for injured service members.

What this program will accomplish:

Military Operational Medicine

- Collection and analysis of experimental data to validate computational models of the direct and indirect mechanism of blast-induced brain injury and inner ear injury
- Delivery of an evidence-based approach to reduce stigma and a training program to increase provider skill in assessing and treating suicidality
- Identification and development of candidate biomarker panels indicative of treatment-related improvement, and animal/human PTSD disease model development

Combat Casualty Care

- Investigation of new diagnostic tools and the development of treatments for severe hemorrhage following injury including novel oxygen carriers for use in severe casualties where blood transfusions are not available
- Advancement of treatments for extremity trauma for wound stabilization in prolonged field care scenarios
- Evaluation of the effectiveness of acute lifesaving interventions and how to improve survival for those in critical care on the battlefield, in acute stages of injury, and for those in prolonged field care scenarios

Clinical and Rehabilitative Medicine

- Selection of products to transition to technology development in the areas of neuro-musculoskeletal injury, pain management, and regenerative medicine
- Identification of targets for therapies to alleviate acute, chronic, and battlefield pain and identification of strategies for addressing psychosocial aspects of pain management and pain-related substance abuse
- Development of candidate reconstructive and regenerative technologies and methodologies for replacement or regeneration of human cells, tissues, or organs for restoration or establishment of normal tissue form and function of bone, skin, muscle, nerve, vasculature and connective tissue

Medical Technology Development Program

The Medical Technology Development Program provides funding for promising candidate solutions that are selected for initial safety and effectiveness testing in animal studies and/or small scale human clinical trials regulated by the US Food and Drug Administration prior to licensing for human use. Key focus areas of the research in the Medical Technology Development Program include care on the battlefield and in field hospitals prior to transporting patients out of theater to CONUS, and studies trauma resuscitation, hemorrhage control, and other life-saving interventions to keep critically wounded patients alive in the golden hour and to the next level of care. Additional goals of this research are to identify cutting edge techniques and technologies that can be employed by Air Force medics during contingency operations and develop medical technology solutions and components of early prototype systems for test and evaluation.

What this program will accomplish:

Expeditionary Medicine Research & Development

- Research and development of therapeutic interventions to sustain life through transfer to definitive care including blood sparing drugs for hemorrhagic shock resuscitation and treatment for neuroprotection, cryopreserved blood products, rhabdomyolysis and ischemia-reperfusion injury
- Evaluation of novel hemorrhage control products that utilize alternative technologies to active hemostatic coatings to provide a lower-cost, safer and more versatile solution to various hemorrhage control pathologies across the continuum of care

Military Operational Medicine

- Refinement and improvement of predictive auditory injury models in order to update acoustic injury standards for health hazard assessment
- Production of individualized treatment guidelines for PTSD as well as PTSD-related sleep disturbances

Combat Casualty Care

- Development of novel technologies to better assess, monitor and maintain the stability of more severely injured TBI casualties closer to point of injury and during prolonged field care
- Demonstration of photochemical cross-linking to strengthen veins for grafting to arteries in wounded warrior surgery and post-surgical benefits of photochemical bonding in reducing scarring and adhesions

Development Research

Medical Products Support and Advanced Concept Development Program

The Medical Products Support and Advanced Concept Development Program provides funding to support advanced concept development of medical products, clinical and field validation studies supporting the transition of products and medical practice guidelines to the military operational user, prototyping, risk reduction and product transition efforts for medical IT applications, and medical simulation and training system technologies. Research in the Medical Products Support and Advanced Concept Development Program supports clinical assessments related to interventions for PTSD and real-time physiological status monitoring. Additionally, the research supports clinical trials such as those assessing biomarkers for TBI, pain management, regenerative medicine and advanced product development related to hemorrhage, extremity trauma, pre-hospital combat casualty care, and en-route care.

What this program will accomplish:

Military Operational Medicine

- Advanced development on a real-time physiological status monitor system
- Development of monitors detecting oxygen toxicity in combat and training environments
- Advance technologies supporting the integrated Soldier Sensor System to include sensor(s) quantifying the impact of energy expenditure and physical load, improved metabolic monitoring in training environments, and the assessment of cognitive status in operational settings

Combat Casualty Care

- Clinical studies on the Wound Stasis System, a product to control non-compressible hemorrhage within a body cavity
- Develop devices to enable first responders to more precisely triage, measure and monitor physiological parameters relevant to the progression of moderate and severe TBI in the battlefield
- Advanced development of technology that electronically captures, records, and transmits combat casualty clinical data during evacuation to higher echelons of care

Clinical and Rehabilitative Medicine

- Validation of regenerative medicine strategies to modulate the immune system in order to reduce the need for lifelong immunosuppression following transplantation
- Advanced clinical trials for oral trans-mucosal Ketamine, a fast acting, easily dispensed oral battlefield pain management product to assess its effectiveness in managing pain after surgery

Medical Products and Support Systems Development Program

The Medical Products and Support Systems Development Program provides funding for system development and demonstration of medical commodities that are directed at meeting validated requirements prior to full-rate initial production and fielding. Development and demonstration activities will be focused in areas such as medical modeling and simulation systems for training/education/treatment, rapid screening for fresh whole blood, spray-dried plasma, and TBI biomarker point of care devices.

What this program will accomplish:

Military Operational Medicine

- Validation, through end-user field testing, of a system-on-a-chip ultra-low power physiologic status monitoring system
- Real-time physiological status monitoring system that integrates algorithms and sensors into actionable real-time physiological status, health, and readiness information

Combat Casualty Care

- Clinical trials to confirm safety and effectiveness of the spray-dried plasma product in diverse populations
- Clinical studies to confirm safety and effectiveness of valproic acid, a drug to prolong survival following severe hemorrhage
- Validation of down-selected point of care device to assess and monitor TBI casualties in the far forward field environment.

Research and Development Program Outlays and Expenses

Program: DHP RDT&E Program *Program Expenses* *(dollars in thousands)*						
Fiscal Year:	**2018-2019**	**2017-2018**	**2016-2017**	**2015-2016**	**2014-2015**	**Total**
Basic Research	$ 658	$ 9,706	$ 25,621	$ 43,752	$ 118,051	$ **197,788**
Applied Research	$ 10,274	$ 75,195	$ 1,424,441	$ 1,336,362	$ 1,047,900	$ **3,894,172**
Development	$ 15,829	$ 154,860	$ 464,761	$ 720,753	$ 1,027,383	$ **2,383,586**
Total	**$ 26,761**	**$ 239,761**	**$ 1,914,823**	**$ 2,100,867**	**$ 2,193,334**	**$ 6,475,546**

**Note: Expenses derived from expenditures reported on the 1002 report.*

Research and Development Program Outcomes and Outputs

Program: DHP RDT&E Program Outcomes and Outputs						
Fiscal Year:	**FY2018**	**FY2017**	**FY2016**	**FY2015**	**FY2014**	**Total**
Programs Transitioned to Advanced Development*	7	4	7	8	0	**26**
Patents/Patent Applications	179	186	226	144	48	**783**
Publications	2,874	2,183	1,726	1,178	630	**8,591**

**Material Development Decision, or beyond, has signed Technology Transition Agreement with developer, or delivered to a Program Manager.*

Required Supplementary Information

Deferred Maintenance and Repairs

Although DHP Enterprise receives the economic benefit and is responsible for the sustainment of various general property, plant and equipment, the DHP Enterprise did not disclose deferred maintenance for FY 2018 in accordance with U.S. GAAP per SFFAS 42, *Deferred Maintenance and Repairs: Amending Statements of Federal Financial Accounting Standards 6, 14, 29, and 32*.

Combining Statement of Budgetary Resources for the year ended September 30, 2018 *(dollars in thousands)*	***Operations, Readiness and Support***	***Procurement***	***Research, Development, Test and Evaluation***	***Family Housing and Military Construction***	***Total Budgetary Accounts***
BUDGETARY RESOURCES					
Unobligated balance from prior year budget authority, net	$ 3,161,945	$ 365,031	$ 1,319,109	$ 906,525	$ 5,752,610
Appropriations (discretionary and mandatory)	31,803,899	498,350	1,871,866	645,295	34,819,410
Spending Authority from offsetting collections (discretionary and mandatory)	3,510,602	(0)	19,353	-	3,529,955
TOTAL BUGETARY RESOURCES	$ 38,476,446	$ 863,381	$ 3,210,328	$ 1,551,820	$ 44,101,975
STATUS OF BUDGETARY RESOURCES					
Total New obligations and upward adjustments	$ 35,821,242	$ 572,738	$ 1,757,424	$ 648,366	$ 38,799,770
Unobligated balance, end of year:					
Apportioned, unexpired accounts	885,408	242,386	1,389,117	840,419	3,357,330
Exempt from apportionment, unexpired accounts	122,809	-	-	-	122,809
Unapportioned, unexpired accounts	4,799	-	-	-	4,799
Unexpired unobligated balance	$ 1,013,016	$ 242,386	$ 1,389,117	$ 840,419	$ 3,484,938
Expired unobligated balance	1,642,188	48,257	63,787	63,035	1,817,267
Total Unobligated balance, end of year	$ 2,655,204	$ 290,643	$ 1,452,904	$ 903,454	$ 5,302,205
TOTAL STATUS OF BUDGETARY RESOURCES	$ 38,476,446	$ 863,381	$ 3,210,328	$ 1,551,820	$ 44,101,975
OUTLAYS, NET					
Outlays, Net (discretionary and mandatory)	$ 30,553,433	$ 427,596	$ 1,335,746	$ 612,326	$ 32,929,101
Distributed offsetting receipts	-	-	(7,811)	-	(7,811)
AGENCY OUTLAYS, NET	**$ 30,553,433**	**$ 427,596**	**$ 1,327,935**	**$ 612,326**	**$ 32,921,290**