

November 1, 2006



# Financial Management

Internal Controls Over Inventory  
Stored at Defense Logistics Agency  
Distribution Depots  
(D-2007-009)

Department of Defense  
Office of Inspector General

Constitution of  
the United States

A Regular Statement of Account of the Receipts and Expenditures of all public Money shall be published from time to time.

Article I, Section 9

### **Additional Copies**

To obtain additional copies of this report, visit the Web site of the Department of Defense Inspector General at <http://www.dodig.mil/audit/reports> or contact the Secondary Reports Distribution Unit at (703) 604-8937 (DSN 664-8937) or fax (703) 604-8932.

### **Suggestions for Future Audits**

To suggest ideas for or to request future audits, contact the Office of the Deputy Inspector General for Auditing at (703) 604-8940 (DSN 664-8940) or fax (703) 604-8932. Ideas and requests can also be mailed to:

ODIG-AUD (ATTN: Audit Suggestions)  
Department of Defense Inspector General  
400 Army Navy Drive (Room 801)  
Arlington, VA 22202-4704

DEPARTMENT OF DEFENSE

**hotline**

**To report fraud, waste, mismanagement, and abuse of authority.**

Send written complaints to: Defense Hotline, The Pentagon, Washington, DC 20301-1900  
Phone: 800.424.9098 e-mail: [hotline@dodig.osd.mil](mailto:hotline@dodig.osd.mil) [www.dodig.mil/hotline](http://www.dodig.mil/hotline)

### **Acronyms**

|     |                                 |
|-----|---------------------------------|
| DDC | Defense Distribution Center     |
| DLA | Defense Logistics Agency        |
| DSS | Distribution Standard System    |
| OMB | Office of Management and Budget |



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

November 1, 2006

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on Internal Controls Over Inventory Stored at Defense Logistics  
Agency Distribution Depots (Report No. D-2007-009)

We are providing this report for information and use. We considered management comments on a draft of this report in preparing the final report.

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

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Amy J. Frontz at (303) 676-7392 or Mr. Anthony C. Hans at (614) 751-1400. See Appendix D for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

*Patricia A. Marsh*

for Paul J. Granetto, CPA  
Assistant Inspector General and Director  
Defense Financial Auditing Service

## Department of Defense Office of Inspector General

Report No. D-2007-009

November 1, 2006

(Project No. D2005-D000FJ-0266.000)

### Internal Controls Over Inventory Stored at Defense Logistics Agency Distribution Depots

#### Executive Summary

**Who Should Read This Report and Why?** DoD personnel involved in the DoD physical inventory control program and DoD managers who rely on Defense Logistics Agency inventory data should read this report. It discusses the internal controls over inventory stored at Defense Logistics Agency distribution depots.

**Background.** Management and distribution of inventories are major logistics functions performed by the Defense Logistics Agency. The Defense Distribution Center is a Defense Logistics Agency activity that is headquarters to 26 worldwide distribution centers that maintain stock in 327 million cubic feet of storage space and process more than 26 million transactions annually. At the end of fiscal year 2005, the distribution centers maintained accountability for 3.9 million stock numbers valued at \$89 billion.

**Results.** DLA has successfully implemented several initiatives to improve controls over inventory stored at its distribution depots. However, a review of the internal controls identified weaknesses in several inventory-related processes. Specifically, Government and contractor personnel did not properly perform physical inventory counts during the execution of statistical sampling plans to measure dollar value and supply record accuracy; the Distribution Standard System contained inaccurate inventory information for individual storage locations; depot personnel did not complete research of inventory discrepancies in a timely manner, retain adequate supporting documentation, or use the proper error codes to identify underlying causes; and accountable officers did not perform consistent or adequate quality checks of completed inventory counts.

The Director, Defense Logistics Agency should ensure that contractor and Government personnel operating the distribution depots and performing inventories are adequately trained and comply with existing inventory policy. Adverse actions should be taken against supervisors who consistently fail to comply with established policy and contractors who fail to meet required accuracy levels. The Director should also establish a standardized methodology to appropriately penalize depots that fail to meet inventory-related performance measures, particularly those depots that have completed the public-private competition required by Office of Management and Budget Circular A-76. In addition, the Director should establish a process for an independent review of the inventory valuation statistical sampling plan results to ensure that the proper values and spreadsheet references are used in the statistical calculations. See the Finding section of the report for the detailed recommendations.

**Management Comments.** The Director of Defense Logistics Agency Logistics Operations concurred with the finding and recommendations. The Director stated that the Defense Distribution Center has developed a recurring training program that focuses

on the processes that impact the accountable balance including receiving, warehousing, inventory control, and stock readiness. The Director stated that the Defense Distribution Center Logistics Division was being reorganized to include a newly established policy division responsible for the oversight of quality checks for distribution performance. The Director stated that the Defense Distribution Center has taken steps to tighten control of the quality check process and will include positive and negative incentives in future contracts for inventory counts. The Director stated that the Defense Distribution Center is working to enhance future contracts for depot operations to include positive and negative incentives as well as an award fee for meeting inventory integrity performance. The Director stated that the Defense Distribution Center will monitor the performance of depots that completed the public-private competition required by Office of Management and Budget Circular A-76 and that failure to meet acceptable performance levels will impact a depot's standing when it comes to qualifying for contract option years. The Director stated that the Defense Logistics Agency has coordinated with the Department of Defense Inspector General to conduct an independent review of the inventory valuation sampling plan results on an annual basis. The Director's comments were fully responsive. Therefore, no additional comments are required. See the finding section of the report for a discussion of management comments and the Management Comments section of the report for a complete text of the comments.

**Management Actions.** Throughout the audit we worked closely with the inventory integrity staff at the Defense Logistics Agency and Defense Distribution Center. We commend them on their aggressive approach to implementing corrective actions in response to interim results memorandums we issued in November 2005 (See Appendix B) and March 2006 (See Appendix C).

# Table of Contents

---

|  |    |
|--|----|
| <b>Executive Summary</b>                                     | i  |
| <b>Background</b>  | 1  |
| <b>Objectives</b>  | 3  |
| <b>Finding</b>   |    |
| DLA Inventory Accuracy                                       | 4  |
| <b>Appendixes</b>  |    |
| A. Scope and Methodology                                     | 15 |
| B. November 2005 Interim Results Memorandum and DLA Response | 17 |
| C. March 2006 Interim Results Memorandum and DLA Response    | 25 |
| D. Report Distribution                                       | 36 |
| <b>Management Comments</b>                                   |    |
| Defense Logistics Agency                                     | 39 |

---

## Background

Management and distribution of inventories are major logistics functions performed by the Defense Logistics Agency (DLA). The Defense Distribution Center (DDC) is headquarters to the 26 DLA worldwide distribution centers. The distribution centers maintain stock in 327 million cubic feet of storage space and process more than 26 million transactions annually. Distribution center inventories consist of clothing and textiles; electronics; industrial, general and construction supplies; subsistence; medical material; and the Military Services' principal end items. At the end of FY 2005, the 26 distribution centers maintained accountability for 3.9 million stock numbers valued at \$89 billion.

**DoD Inventory Accuracy Policy.** DoD 4000.25-2-M, "Military Standard Transaction Reporting and Accounting Procedures," September 2001, provides guidance on the DoD physical inventory control program for all DoD Components. The purpose of the DoD physical inventory control program is to:

- ensure that DoD activities properly execute materiel accountability;
- ensure that DoD activities maintain accurate property accountability records for the physical inventory in support of customer requirements and readiness and perform physical inventories, location surveys, and reconciliations;
- identify and help resolve problems in supply system work processes affecting property accountability records by performing quality control of the work processes; and
- identify repetitive processing errors and maintain accurate records for supply system transactions by researching and reconciling property accountability record imbalances and potential discrepancies.

The DoD storage activity maintains the property accountability records for all materiel in storage regardless of ownership and maintains transaction histories to support the balance records. Maintenance of these records provides the capability to detect theft or diversion of materiel and improves the ability to determine the cause of inventory variances for corrective action.

**DLA Depot Inventory Operations.** Inventory integrity is a major function of each DLA distribution depot, and assigned personnel conduct physical inventories, location surveys, research of inventory adjustments, shelf life date inspections, and surveillance inspections. Assigned personnel execute inventory adjustments and maintain the accountable inventory records. The "accountable officer" is a command staff position to oversee the inventory program. DLA relies on an automated information system to manage inventory. The Distribution Standard System (DSS) integrates all the basic distribution center operations of receiving, storage, shipping, inventory, and transportation. DSS also incorporates space planning, production control, and performance planning and also controls the use of materiel handling equipment.

**Inventory Statistical Sampling Plans.** DLA relies on statistical sampling techniques to measure the accuracy of the depot inventory records. To obtain useful and reliable information from a statistical sample, the sampling techniques must be statistically valid and properly applied and produce results within acceptable levels of confidence and precision. DLA uses separate statistical sampling plans to measure inventory record accuracy and dollar value accuracy.

**DoD Record Accuracy Inventory Sample Plan.** DLA executes a record accuracy inventory sample plan during the second and fourth quarters of each fiscal year. The results of the record accuracy sample plan are used as the primary performance measure to assess inventory accuracy at the DLA depots. The record accuracy sample plan is performed to meet the requirements specified in DoD Manual 4000.25-2-M, which requires that a stratified, hierarchal inventory sample be accomplished at least once annually for the purpose of validating the accuracy of the accountable record. The record accuracy sample is to be based on a 95-percent confidence level with a plus or minus error bound of 4 percent applicable to each category. Details on the stratification categories and tolerances of the record accuracy sample plan are provided in Table 1.

| <b>Table 1. Record Accuracy Sample Categories</b>  |             |                  |
|--|-------------|------------------|
| <u>Category - Description</u>  | <u>Goal</u> | <u>Tolerance</u> |
| A - Unit price $\geq$ \$1,000  | 99%         | 0                |
| B - Unit of issue other than each or, on-hand balance $>50$ and extended value $<$ \$50,000 or, annual transaction activity $> 50$ | 95%         | 10%              |
| C - Date of last inventory $> 24$ months and on-hand balance $< 50$  | 95%         | 5%               |
| D - All other material   | 95%         | 0                |

**DLA Inventory Valuation Statistical Sample Plan.** DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume 11B, December 1994, requires that physical inventory counts provide reasonable assurance that logistics records accurately reflect the dollar value of assets stored. If inventory size prevents a 100-percent count, the regulation requires that valid statistical sampling techniques be used to provide assurance that the dollar value recorded in the general ledger accounts is accurate, with at least a 90-percent confidence level and a precision level of plus or minus 2.5 percent. DLA executes an Inventory Valuation Statistical Sampling Plan at the end of each fiscal year to meet these requirements. The plan includes only DLA-owned assets and uses a higher confidence level of 95 percent.

**Public-Private Competition of Depot Operations.** In March 1998, DLA announced that most of its distribution depots would undergo public-private competition using the guidelines of Office of Management and Budget (OMB) Circular A-76, "Performance of Commercial Activities," August 4, 1983 (revised 2003). The process establishes Federal policy for deciding whether to retain recurring, commercial-like activities within the Government, or contract them out

---

to a private sector source. The guidance tells how to compare performance and cost related information to arrive at the best overall deal for the taxpayer. To date, 12 distribution depots have formally completed the public-private competition process and the operations for 6 were awarded to private contractors and operations for the remaining 6 were awarded to a workforce of Federal Government employees.

## Objectives

Our overall audit objective was to evaluate the controls over inventory stored at DLA distribution depots. Specifically, we evaluated the physical inventory control program and related inventory sampling plans. We also reviewed the management control program as it relates to the audit objectives. See Appendix A for a discussion of the scope and methodology.

## Review of Internal Controls

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Manager's Internal Control Program Procedures," August 28, 1996,<sup>1</sup> require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

We evaluated DLA internal controls and management's self-evaluation of internal controls over inventory stored at DLA distribution depots. Specifically, we focused on DLA's physical inventory control program and its FY 2005 Annual Statement of Assurance. We identified DLA management control weaknesses, as defined by DoD Instruction 5010.40. Internal controls did not ensure that personnel operating the distribution depots and conducting inventories complied with existing DLA policy on inventory accuracy. DLA did not identify or report the management control weaknesses identified by the audit in its FY 2005 Annual Statement of Assurance. The details of the management control weaknesses are provided in the Finding section of this report. The recommendations in this report, if implemented, will improve the accuracy and reliability of inventory stored at DLA distribution depots. A copy of the report will be provided to the senior official responsible for DLA management controls.

---

<sup>1</sup> Our review of the internal controls was done under the auspices of DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996. DoD Directive 5010.38 was cancelled on April 3, 2006. DoD Instruction 5010.40, "Managers' Internal Control Program Procedures," was reissued on January 4, 2006.

---

## DLA Inventory Accuracy

DLA has successfully implemented several initiatives to improve controls over inventory stored at its distribution depots. However, a review of the internal controls identified weaknesses in several inventory-related processes. Specifically,

- Government and contractor personnel did not properly perform physical inventory counts during the execution of statistical sampling plans to measure dollar value and supply record accuracy,
- depot personnel did not ensure that DSS contained accurate inventory information for individual storage locations,
- depot personnel did not complete research of inventory discrepancies in a timely manner, retain adequate supporting documentation, or use the proper error codes to identify underlying causes, and
- accountable officers did not perform consistent or adequate quality checks of completed inventory counts.

The control weaknesses occurred because personnel responsible for operating the distribution depots and conducting the inventories did not consistently follow standard operating procedures and procedures for performing quality checks of inventory counts were not adequate. In addition, staffing problems exacerbated the control weaknesses at depots that had completed the public-private competition process required by OMB Circular A-76. The control weaknesses impact the overall integrity of the DLA perpetual inventory records and have contributed to inventory record accuracy rates that have consistently fallen short of DoD performance goals. DoD managers rely on the perpetual inventory records for accurate information on which they base purchase and other important inventory management decisions.

## DLA Inventory Improvement Initiatives

**DDC Swarm Initiative.** In March 2003, the Defense Distribution Center (DDC) began implementation of a “swarm initiative” for inventory accuracy improvement. Swarm was a concept instituted by DDC to apply increased resources to correct a problem quickly and comprehensively. DDC developed a six step process that involved: DSS enhancements to prevent errors, retraining the workforce, cleaning up the warehouses, correcting the records, providing tools to maintain inventory accuracy, and holding employees accountable. The swarm training included four modules to improve the processes that most directly impact inventory accuracy. The modules included stock readiness, inventory, receiving, and warehousing. The warehouse cleanup process involved re-warehousing, location surveys, wall-to-wall inventories, care of supplies in storage, and more

frequent sample inventories. The baseline for completion of the swarm initiative was February 2006. DDC used the results of the second quarter FY 2006 record accuracy sample to measure the success of the swarm initiative at the individual depots. The results showed that 15 of the 26 depots met all record accuracy goals. Overall, record accuracy rates have steadily improved during swarm.

**Independent Inventory Counters.** DLA has contracted with a private sector firm to perform physical inventories at some of the depots included in the statistical sampling plans to measure dollar value and supply record accuracy. This contracting effort is separate from the OMB Circular A-76 contracting effort and allows for the performance of physical inventory counts by an outside party that is independent of the parties normally responsible for depot operations. The contractor is required to follow DLA policy and procedures when performing the inventories and is required to maintain a 99 percent accuracy rate.

## Results of Internal Control Tests

Tests of the internal controls identified weaknesses in several inventory-related processes including physical count procedures, DSS record accuracy, research of inventory discrepancies, and quality control checks. We performed physical inventory observations and related tests of controls at 17 DLA distribution depots (Appendix A lists sites visited). We performed the control reviews in September 2005 at all four depots that were included in the FY 2005 DLA inventory valuation statistical sample plan, and the results were summarized in an interim results memorandum issued to DDC on November 14, 2005 (see Appendix B). We performed additional control reviews in February and March 2006 at 14 depots<sup>2</sup> that were included in the second quarter FY 2006 record accuracy inventory sample plan. The results of the control reviews at all depots are summarized in Table 2.

| <b>Table 2. Summary of Internal Control Tests</b> |                     |                      |
|---|---------------------|----------------------|
| <u>Type of Control Test</u>                       | <u>No. of Tests</u> | <u>Discrepancies</u> |
| Physical Inventory Observations                   | 1,634               | 15                   |
| Auditor-Observed Recounts                         | 403                 | 13                   |
| Floor-To-Record Tests                             | 1,058               | 48                   |
| Reverse Inventories                               | 238                 | 10                   |
| Inventory Adjustment Voucher Review               | 73                  | 26                   |

**Physical Inventory Counts.** Government and contractor personnel did not properly perform physical inventory counts during the execution of statistical sampling plans to measure dollar value and supply record accuracy. Observations of inventories is a generally accepted auditing procedure. In circumstances where

<sup>2</sup> The 14 depots include the Defense Depot Oklahoma City, Oklahoma, which was also visited in September 2005 because it was selected as part of the Inventory Valuation Statistical Sampling Plan.

---

activities use statistical sampling, auditors must be satisfied that the client's procedures or methods are sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year. Auditors must observe such counts as they deem necessary and must be satisfied as to the effectiveness of the counting procedures used.

According to DLA policy, personnel conducting the inventories are required to visit all warehouse locations for a particular stock number. At each location, personnel are required to verify the stock number, the code identifying the condition of the material (serviceable, unserviceable, etc), the unit of issue code identifying how material is issued (each, by the box, etc), and physically count each item of stock. Personnel are required to open all boxes that do not have an original factory seal. DLA policy also requires that radio frequency devices be used to conduct physical inventories. The radio frequency devices are used to scan bar codes containing item information, input counts, and allow for real time processing of inventory data.

**Auditor Observations of Physical Inventory Counts.** The contractor and Government personnel performing the physical inventories were generally following DDC guidelines for the 1,634 inventories that were observed. However, there were 15 instances where the DDC procedures were not followed. For instance, personnel did not always open boxes that were not factory sealed and remove and count the contents. In other cases, personnel did not validate condition codes and units of issue when conducting the physical counts.

Control reviews performed in September 2005 revealed that contractor employees were not consistently using radio frequency devices to record inventory count information at two of the four depots visited. We informed DDC of this deficiency in the interim results memorandum we sent to them in November 2005 (Appendix B) and DDC implemented corrective actions. Subsequent control reviews performed in February and March 2006 revealed that depot personnel consistently used radio frequency devices at 13 of the 14 depots.

DDC personnel informed us in August 2005 that DSS was modified to restrict access to quantities previously recorded for specific warehouse locations so that counters could not look up the information prior to performing the inventories. Control reviews performed in September 2005 found that contractors performing the counts were able to access the DSS location quantity information. DDC was informed of this deficiency in the November 2005 interim results memorandum. Subsequent control reviews performed in February and March 2006 determined that the DSS modification was successfully implemented at most sites to restrict access to previously recorded location quantities.

**Auditor-Observed Recounts of Recently Completed Inventories.** Auditor-observed recounts of recently completed sample inventories were performed during control reviews in February and March 2006. A total of 403 recounts were performed and there were 13 instances where the recounted quantity did not match the quantity recorded in DSS. Errors identified during the recounts raise concerns about the integrity of the statistical sample results. For example, recounts at the Defense Depot in Albany, Georgia identified 6 errors in

---

57 stock numbers that had recently been inventoried as part of the second quarter FY 2006 record accuracy sample plan.

**DSS Inventory Record Accuracy.** DSS contained inaccurate inventory information for individual storage locations. Floor-to-record tests were performed to determine if stock information for selected warehouse locations was properly recorded in DSS. Floor-to-record control tests of 1,058 randomly selected locations identified 48 instances where the stock information for specific warehouse locations was not properly recorded in DSS.

For example, a control review performed at the Defense Distribution Depot Anniston, Alabama, in February 2006 identified numerous inventory record accuracy problems. Record accuracy control tests of 50 locations identified 21 instances where the stock information for a given location was not properly recorded in DSS. In addition, the auditor performing the site visit coordinated with the depot security officer to have pictures taken to document poor warehouse conditions including a number of potential safety issues and damaged stock. We issued an interim results memorandum to DDC on March 8, 2006, requesting immediate management action on these issues (see Appendix C).

DDC provided an official response to the interim results memorandum, which stated that a whistleblower complaint was filed in August 2005 reporting improper care of material in storage. The response also describes the corrective action plan subsequently developed, which includes re-training responsible personnel, proper item packaging, command-level adverse actions against negligent supervisors, improved leadership accountability, location surveys, inventories, and condition inspections of potentially damaged material in all warehouses. In addition, the response says that a DDC Health and Safety audit was conducted in March 2006. We were concerned from an audit perspective about the timeliness of the corrective actions and the fact that the safety inspection did not occur until a month after our site visit.

The floor-to-record test was expanded at three depots to include tracing quantities for selected locations back to DSS. For 238 locations tested, the quantities physically counted at 10 locations differed from the quantities recorded in DSS.

**Research of Inventory Discrepancies.** Depot personnel did not complete research of inventory discrepancies in a timely manner, retain adequate supporting documentation, or use the proper error codes to identify underlying causes. DoD policy states that the analysis of inventory adjustments is vital in order to: identify failures in the control systems; reduce similar discrepancies in the future; ensure proper adjustments were made; evaluate indicators of trends or system problems; and detect negligence, abuse, or theft of materiel. Adjustment research must be completed within 45 days in order to increase the probability of conclusive findings. Error conditions are required to be categorized by the warehouse operation in which they occurred (e.g., receiving) and classified by type of error within that operation by an assigned error classification code.

Inventory adjustment vouchers are generated for adjustments meeting the criteria established in DoD 4000.25-2-M and are used to initiate the causative research process. Populations of inventory adjustment vouchers were obtained from DDC

---

and analyzed to determine if depots completed the research within the required 45-day timeframe. On October 18, 2005, open adjustment vouchers totaled 2,516 and 727 of those were more than 45 days old. On January 23, 2006, open adjustment vouchers totaled 5,800 and 2,795 were more than 45 days old.

We analyzed a sample of 73 completed inventory adjustment vouchers as part of our control reviews in February and March 2006. Inventory adjustment vouchers were reviewed to determine whether the cause of the adjustment was properly identified and classified by the appropriate error classification code in accordance with DoD policy. We analyzed all documentation supporting the research and the assigned error classification code. Of the 73 vouchers reviewed, 26 contained error classification codes that were either incorrect or not adequately supported.

For example, deficiencies were identified with all five completed inventory adjustment vouchers that were reviewed at the Defense Depot Albany, Georgia. For two of the vouchers, depot personnel did not assign the proper classification code to identify the operation where the error occurred. For the remaining three vouchers, depot personnel did not perform adequate research to support the assigned error classification code.

**Quality Control Over Inventory Counts** Accountable officers did not perform consistent or adequate quality checks of completed inventory counts. DDC issued quality control guidance to all depot commanders and accountable officers on July 25, 2005. The DDC guidance provided detailed instructions on the point of sampling (population), determining sample sizes, random sampling methodology, a 99-percent acceptable quality rate, and reporting of results. The quantities at each location were required to be physically verified by the accountable officer or designee to ensure that the original physical count was accurate.

Control reviews performed in September 2005 revealed that accountable officers did not consistently follow existing DDC quality control guidance at three of the four depots visited. We reported this problem to DDC in the interim results memorandum we sent to them on November 14, 2005 (see Appendix B). DDC issued revised quality control guidance on January 20, 2006. Subsequent control reviews performed in February and March 2006 found that the quality check process had significantly improved. Accountable officers at 13 of the 15 depots we visited were substantially complying with the revised policy. The results of the improved quality control checks were effective in showing that physical inventory counts required improvement at both contractor-and Government-operated depots. For seven depots involved in the second quarter FY 2006 record accuracy sample plan, the results of the quality checks were below the 99-percent acceptable quality rate established by DDC.

## **Existing Inventory Control Procedures**

The control weaknesses occurred because personnel operating the distribution depots did not consistently follow existing procedures and some of the procedures were inadequate.

---

**Compliance with Existing Procedures.** DDC established an extensive training program on inventory control. As part of the swarm effort, a detailed inventory control module was developed and training was provided to more than 700 depot employees, including contractors. In addition, DDC provided training on the physical inventory process to the depot accountable officers in January 2005. DDC also provided training on the physical inventory process to the site managers of the contractor hired by DLA to perform physical inventories at depots included in inventory sampling plans. Despite DDC's efforts, personnel operating the distribution depots and performing physical inventories did not always comply with the procedures they were trained to follow.

**Adequacy of Existing Procedures.** DLA issued extensive guidance that more than adequately explained the DLA requirements for performing physical inventories and determining the cause of supply discrepancies. Specifically, DLA developed separate chapters in its DSS Users Manual and separate sections in its Swarm Inventory Control Training Module with detailed instructions on performing physical inventories and conducting causative research. DDC also issued additional guidance on conducting physical inventories prior to the execution of the second quarter FY 2006 record accuracy inventory sample.

DDC also issued quality control guidance to all depot commanders and accountable officers on July 25, 2005. Our review of the guidance and discussions with personnel responsible for its execution disclosed areas that required improvement. This information was provided to DDC in the interim results memorandum issued on November 14, 2005. DDC agreed that the quality check guidance was not consistently implemented and required clarification. DDC issued revised guidance on the quality check process on January 20, 2006, which addressed the deficiencies identified by our review.

## **OMB Circular A-76 Results**

Staffing problems exacerbated the control weaknesses at depots that had completed the public-private competition (OMB Circular A-76). At the time of this audit, operations at six depots were awarded to private contractors and operations for six depots were awarded to a workforce of Federal Government employees. The contracts for depot operations were generally awarded for 3 base years with 2 additional option years. The public-private competition has led to a very unstable workforce at the depots.

Depots completing the OMB Circular A-76 requirements that have experienced inventory accuracy problems have developed detailed corrective actions plans for DDC oversight. In the more recent contracts, DDC has inserted a clause to penalize contractors that don't meet inventory accuracy goals. A methodology has not been established to penalize the Government-operated depots.

**Contractor-Operated Depots.** The option years were not exercised on the initial contracts at four of six contractor-operated depots, and the resolicitations were all awarded to new contractors resulting in an unstable workforce (See Table 3).

| <b>Table 3. Depots Operated by Contractors</b> |   |
|--|---|
| <u>Depot</u>                                   | <u>Current Status</u>                             |
| Barstow  | Initial contractor won resolicitation             |
| Hill   | Initial contractor awarded option years           |
| Warner Robins                                  | Option years not awarded. New contractor in place |
| Cherry Point                                   | Option years not awarded. New contractor in place |
| Jacksonville                                   | Option years not awarded. New contractor in place |
| San Diego                                      | Option years not awarded. New contractor in place |

Contractor-operated depots have failed to consistently achieve DoD inventory record accuracy goals. Specifically, five of the six contractor-operated depots failed to meet the goals established for all four categories of the second quarter FY 2006 record accuracy statistical sample plan. For example, the operations for the defense depot in Warner Robins, Georgia, were awarded to a contractor and the first performance period began in September 2000. The option years were not exercised and the resolicitation was awarded to another contractor. The new performance period began in December 2004. In January 2006 there were 1,663 open inventory adjustment vouchers that were more than 45 days old, and control reviews performed in February 2006 identified numerous deficiencies. In addition, the depot did not achieve the goals established for three of the four categories of the second quarter FY 2006 record accuracy sample plan.

DLA is in the process of transforming existing logistics processes by creating four support regions within the Continental United States. Each will have one “strategic distribution platform.” The Warner Robins depot is scheduled to become one of DLA’s four strategic distribution platforms. The inventory-related performance issues identified at the Warner Robins depot create concerns regarding its ability to successfully operate as a strategic distribution platform unless significant improvements are made. The Warner Robins depot has developed a detailed corrective action plan. However, DLA must provide sufficient oversight to ensure successful implementation of corrective actions.

**Government-Operated Depots.** The option years were not exercised at one Government-operated depot and are to be resolicited (See Table 4).

| <b>Table 4. Depots Operated by a Federal Workforce</b> |   |
|--|---|
| <u>Depot</u>   | <u>Current Status</u>                   |
| Columbus   | Initial Government operation in place   |
| Albany   | Initial Government operation in place   |
| Corpus Christi   | Initial Government operation in place   |
| Puget Sound  | Initial Government operation in place   |
| Tobyhanna  | Initial Government operation in place   |
| Richmond   | Option years not awarded. Resoliciting. |

Government-operated depots have also failed to consistently achieve DoD inventory record accuracy goals. Specifically, three of the six Government-operated depots failed to meet the goals established for all 4 categories of the second quarter FY 2006 record accuracy statistical sample plan.

For example, the operations for the Corpus Christi, Texas, depot were awarded to a workforce of Federal employees and June 1, 2005, was the start of the initial performance period. Staff responsible for inventories and related research were subsequently reduced from 17 to 3. Control reviews performed in September 2005 identified numerous deficiencies, and in January 2006 there were 558 open inventory adjustment vouchers that had not been completed within the required 45 days. In addition, the depot did not achieve any of the goals established for the four categories of the second quarter FY 2006 record accuracy sample plan.

## Impact of Internal Control Deficiencies

The control weaknesses impact the overall integrity of the DLA perpetual inventory records and have contributed to inventory record accuracy rates that consistently fall short of DoD performance goals. Lack of accurate inventory records encumbers DoD managers who rely on the perpetual inventory records for information they need to make purchase and other important inventory management decisions. The combined weighted average record accuracy sample results for all depots from the fourth quarter FY 2000 through the second quarter FY 2006 are provided in Table 5.

| <b>Table 5. Combined Record Accuracy Sample Results<br/>4th Quarter FY 2000 - 2nd Quarter FY 2006</b> |                |                |                |                |
|---|----------------|----------------|----------------|----------------|
| Sample Category* (Accuracy Percent Goal)  |                |                |                |                |
| <u>FY - Quarter</u>   | <u>A (99%)</u> | <u>B (95%)</u> | <u>C (95%)</u> | <u>D (95%)</u> |
| 2000 - 4th  | 96             | 91             | 91             | 92             |
| 2001 - 2nd  | 97             | 92             | 92             | 94             |
| 2001 - 4th  | 95             | 92             | 89             | 93             |
| 2002 - 2nd  | 96             | 91             | 91             | 94             |
| 2002 - 4th  | 96             | 91             | 94             | 93             |
| 2003 - 2nd  | 96             | 91             | 92             | 91             |
| 2003 - 4th  | 97             | 91             | 94             | 92             |
| 2004 - 2nd  | 96             | 91             | 95             | 92             |
| 2004 - 4th  | 96             | 91             | 94             | 94             |
| 2005 - 2nd  | 97             | 93             | 93             | 94             |
| 2005 - 4th  | 97             | 93             | 93             | 96             |
| 2006 - 2nd  | 97             | 95             | 94             | 96             |
| *See Table 1 for detailed descriptions of the sample categories                                       |                |                |                |                |

---

## Other Matters of Interest

Analysis of the FY 2005 inventory valuation sample plan results identified errors in the mechanics of the sample plan as well as a high error rate. In circumstances where activities use statistical sampling, generally accepted auditing procedures require that auditors must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that its results are reasonable.

The first error identified with the statistical mechanics of the sample plan involved the methodology used to calculate the error bounds for net inventory dollar misstatement. Specifically, the DLA sample plan methodology uses a “t-value” in the error bound calculation, which is dependent on the number of sample sites. DLA incorrectly used a t-value of 2.09 when a t-value of 2.26 should have been used. For the 2004 DLA sample plan, a total of 20 sample sites were selected and the appropriate t-value was 2.09. However, DLA reduced the sample size to 10 for the 2005 sample plan without adjusting the t-value accordingly to 2.26.

The second error involved an incorrect cell reference in the sample projections of the sample results for the Corpus Christi depot. Specifically, the average misstatement for strata 1 was incorrectly referenced to a cell containing the results of an individual item adjustment for \$2,911. The cell for the average misstatement for strata 1 should have been referenced to the average adjustments for strata 1 which contained a value of \$137.

The two errors impacted the sample projections but did not result in a material variance. The estimated inventory value decreased from \$11,521,296,003 to \$11,482,730,958 and the error bound increased from \$84,632,442 to \$100,220,788. The inventory estimate range (the estimated inventory value plus and minus the error bound) changed from \$11,436,663,566 (lower bound) and \$11,605,928,449 (upper bound) to \$11,382,510,171 and \$11,582,951,746, respectively. However, the revised range still fell within the overall materiality range of \$11,267,342,337 and \$11,845,154,765.

Analysis of the FY 2005 DLA inventory valuation statistical sampling plan result also revealed a high error rate in regards to the number of physical inventory adjustments. The purpose of the inventory valuation statistical sampling plan is to assess the accuracy of the inventory value presented on the DLA financial statements. However, the analysis of the sample results identified a significant number of physical inventory adjustments that raised concerns from an internal control perspective. Statistical estimates of the misstatement percentage were calculated using the existing formulas and parameters in the sampling plan. The statistical estimate of the misstatement percentage (error rate) was calculated at approximately 12 percent, which exceeded the 5-percent maximum error rate established for DoD inventory record accuracy.

---

## Summary

DLA has successfully implemented several initiatives to improve controls over inventory stored at its distribution depots, and inventory record accuracy rates have improved over the past 5 years. However, additional improvements are necessary to ensure that all DoD inventory accuracy goals are consistently achieved. Our control reviews identified weaknesses in several inventory-related processes including physical count procedures, DSS record accuracy, research of inventory discrepancies, and quality control checks. In addition, staffing problems exacerbated the control weaknesses at depots that had completed the public-private competition process required by OMB Circular A-76. While the existing policies and procedures provide sufficient guidance on maintaining inventory accuracy, DLA needs to provide oversight to ensure full compliance by contractor and Government personnel responsible for depot operations. This is especially important considering the unstable environment resulting from the implementation of OMB Circular A-76.

## Recommendations and Management Comments

**We recommend that the Director, Defense Logistics Agency:**

**1. Require that all contractor and Government personnel responsible for operating the distribution depots complete sufficient training and comply with inventory accuracy requirements for physical inventory counts, storage practices, discrepancies research, and quality checks. Adverse actions should be taken against supervisors who consistently fail to comply with established policy.**

**Management Comments.** The Director of Defense Logistics Agency Logistics Operations concurred with the recommendation. The Director stated that the Defense Distribution Center has developed a recurring training program that focuses on the processes that impact the accountable balance including receiving, warehousing, inventory control, and stock readiness. The Director also stated that the Defense Distribution Center Logistics Division is currently reorganizing and includes a newly established policy division that will have oversight of quality checks for distribution performance.

**2. Use the revised quality check process to enforce the 99-percent accuracy requirement for contractor-performed inventory counts, and apply the appropriate penalties for any shortfalls.**

**Management Comments.** The Director of Defense Logistics Agency Logistics Operations concurred with the recommendation. The Director stated that the Defense Distribution Center has taken steps to tighten control of the quality check process and will include positive and negative incentives in future contracts for inventory counts.

---

**3. Establish a standardized methodology to appropriately penalize contractor and Government operated depots that consistently fail to meet inventory-related performance measures, particularly those depots that have completed the public-private competition required by Office of Management and Budget Circular A-76.**

**Management Comments.** The Director of Defense Logistics Agency Logistics Operations concurred with the recommendation. The Director stated that the Defense Distribution Center Contracting Office is working to enhance future contracts to include positive and negative incentives as well as an award fee for meeting inventory integrity performance. The Director also stated that Defense Distribution Center Contracting and Operations Directorates will monitor the performance of depots that completed the public-private competition required by Office of Management and Budget Circular A-76 and that failure to meet acceptable performance levels will impact a depot's standing as a high performing activity when it comes to qualifying for contract option years.

**4. Establish a process for an independent review of the inventory valuation statistical sampling plan results to ensure that the proper values and spreadsheet references are used in the statistical calculations.**

**Management Comments.** The Director of Defense Logistics Agency Logistics Operations concurred with the recommendation. The Director stated that the Defense Logistics Agency has coordinated with the Department of Defense Inspector General to conduct an independent review of the inventory valuation sampling plan results on an annual basis.

---

## Appendix A. Scope and Methodology

We performed this audit from August 2005 through August 2006 in accordance with generally accepted government auditing standards. The audit was performed at DLA headquarters, DDC, and the 17 distribution depots listed in Table A.

| <u>Defense Distribution Depot</u> | <u>Month(s) Visited</u>     |
|-----------------------------------|-----------------------------|
| San Joaquin, California           | September 2005              |
| Susquehanna, Pennsylvania         | September 2005              |
| Corpus Christi, Texas             | September 2005              |
| Oklahoma City, Oklahoma           | September 2005 & March 2006 |
| Barstow, California               | February 2006               |
| Anniston, Alabama                 | February 2006               |
| Red River, Texas                  | February 2006               |
| Norfolk, Virginia                 | February 2006               |
| Warner Robins, Georgia            | February 2006               |
| Albany, Georgia                   | February 2006               |
| Cherry Point, North Carolina      | February 2006               |
| Hill, Utah                        | February 2006               |
| Jacksonville, Florida             | February 2006               |
| Tobyhanna, Pennsylvania           | February 2006               |
| San Diego, California             | February 2006               |
| Germersheim, Germany              | February 2006               |
| Yokosuka, Japan                   | March 2006                  |

We evaluated the physical inventory control program and related inventory sampling plans. The control reviews at the distribution depots involved observations of 1,634 physical inventories performed by depot personnel during execution of the FY 2005 inventory valuation statistical sample plan and the second quarter FY 2006 record accuracy sample plan. The control reviews also involved 403 auditor recounts of items included in the second quarter FY 2006 record accuracy sample plan that had been recently inventoried by depot personnel. In addition, we evaluated the depot quality checks over the physical inventory counts performed by Government and contractor personnel.

A limited test of record accuracy controls was also performed to determine if stock information for selected warehouse locations was properly recorded in DSS. During the inventories, we randomly selected 1,058 nearby locations and determined whether the stock information was properly recorded in DSS. In addition, a judgmental sample of 73 completed inventory adjustment vouchers was analyzed as part of the control reviews performed in February and March 2006. The population of completed vouchers consisted of those that existed in the October 2005 population that had been completed and did not exist in the January

---

2006 population that DDC provided. Our scope was limited in that we did not evaluate the mechanics of the DoD Record Accuracy Inventory Sample Plan.

**Use of Computer-Processed Data.** DLA used computer-processed data from DSS to select the items for the statistical sampling plans it used to measure dollar value and supply record accuracy. We did not test the general and application controls in DSS and did not make any conclusions about the reliability of the data. We performed other tests to determine the reliability of the data. Specifically, we performed physical inventory observations, auditor recounts, and floor to record tests to determine the accuracy of the DSS inventory records.

**Use of Technical Assistance.** Inspector General, DoD, Quantitative Methods Division personnel provided assistance in evaluating the FY 2005 DLA inventory valuation statistical sampling plan. During the evaluation, a significant number of errors were identified that raised concerns from an internal control perspective. Statistical estimates of the misstatement percentage were calculated using the formulas and parameters in the FY 2005 DLA inventory valuation statistical sampling plan. The statistical estimate of misstatement percentage was 11.83 percent with an error bound of 3.56 percent. Therefore, the estimated misstatement range is 8.27 percent (lower bound) to 15.39 percent (upper bound).

**Government Accountability Office High-Risk Area.** The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the DoD Supply Chain Management (formerly Inventory Management) high-risk area.

## **Prior Coverage**

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

# Appendix B. November 2005 Interim Results Memorandum and DLA Response



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
OFFICE OF THE ASSISTANT INSPECTOR GENERAL FOR AUDITING  
630 MORRISON ROAD, SUITE 310  
GAHANNA, OH 43230-5327

November 14, 2005

MEMORANDUM FOR COMMANDER, DEFENSE DISTRIBUTION CENTER

SUBJECT: Audit of the Internal Controls Over Inventory Stored at Defense Logistics Agency Distribution Depots (Project No. D2005-D000FJ-0266)

During the initial phase of our audit we reviewed the execution of the Defense Logistics Agency (DLA) FY 2005 Chief Financial Officer's (CFO) Inventory Valuation Sampling Plan. We performed our review at the Defense Distribution Center (DDC) and at the following sites that were selected as part of the sample: the Defense Depot San Joaquin California (DDJC), the Defense Depot Susquehanna Pennsylvania (DDSP), the Defense Depot Oklahoma City Oklahoma (DDOO), and the Defense Depot Corpus Christi Texas (DDCT). During the course of our review, we noted improvements with the physical inventory counts performed by contractor personnel. However, we identified control deficiencies that continue to impact the integrity of the sample plan. These control deficiencies are outlined in the attachment to this memorandum.

We are providing this information prior to issuing a formal report to allow DDC time to take corrective actions before the record accuracy sample takes place in February 2006. Once our field work is completed we will issue a formal audit report, which will incorporate this memorandum and any corrective actions taken by DDC. We request that DDC provide a response within 30 days and describe the actions taken or planned in response to this memorandum.

If you have any questions or need additional information regarding this memorandum, please contact Mr. James L. Kornides at (614) 751-1400 (jkornides@dodig.osd.mil) or Ms. Amy J. Frontz at (614) 751-1400 (afrontz@dodig.osd.mil).



James L. Kornides  
Program Director  
Defense Financial Auditing  
Service

---

## Attachment

**Background.** The overall audit objective was to evaluate the controls over inventory stored at the DLA Distribution Depots including the physical inventory control program and related inventory sampling plans. For this part of the audit, we reviewed the execution of the physical inventories for a statistical sample of items included as part of the FY 2005 DLA CFO Inventory Sampling Plan. In addition, we performed other limited tests of controls. The DLA Office of Research and Resource Analysis selected the sample on August 30, 2005. A total of four Distribution Depots were selected in the first stage of the sample: DDJC, DDSP, DDOO, and DDCT. The sample items were loaded into the Distribution Standard System (DSS) to allow for the physical inventories to begin on September 1, 2005. DDC contracted with Tessada & Associates (contractor) to perform the physical inventories. Quality checks of the contractor's inventory counts were required to be performed in accordance with DDC guidelines.

**Summary of Observations.** During the course of our review, we identified control deficiencies that impact the integrity of the sample plan. These deficiencies involved contractor physical count procedures, contractor access to location quantities, depot quality control procedures, and general depot warehousing practices.

### Contractor Physical Count Procedures

Contractor employees were generally following DDC physical inventory guidelines on segregation of duties, physically counting material, validating the correct item information, pulling stock out of locations, and opening non-factory-sealed boxes. This represents a significant improvement from previous years. However, contractor employees did not consistently use the Radio Frequency (RF) devices at DDJC and DDOO. The Statement of Work for the contractor-performed inventories states that inventories will be conducted in both RF and non-RF environments depending on availability of equipment, distribution center practices, and location of inventories. The DDJC Accountable Officer stated that it was standard practice to use the RF devices and that contractor personnel were provided sufficient training and equipment to complete their work. The DDOO Accountable Officer made the decision not to train contractor personnel on the RF devices. Failure to use the RF devices can result in erroneous adjustments resulting from in float transactions that occur during the inventories.

### Contractor Access to Location Quantities

DDC personnel informed us during our initial site visit that a counter profile had been created in DSS to restrict access of DSS programs that would be detrimental to the integrity of the sample inventory process. The inventory counters would be able to access the programs necessary to input counts but the ability for counters to access the DSS quantity by location (QBL) was removed to eliminate the performance of QBL counts. We tested the DSS profile and found that contractor personnel were able to access the DSS QBL at all four sites visited. During our limited review of the FY 2005 CFO Sample inventories, we did not witness contractor personnel performing QBL counts. However, QBL counts were identified as a prior audit deficiency and the risk exists that they may occur when auditors are not present.

---

## Attachment

### Depot Quality Control Procedures

Prior to visiting the depots, we obtained the most recent quality control guidance that DDC issued to all Depot Commanders and Accountable Officers on July 25, 2005. The guidance was issued to the depots in preparation for the August 2005 record accuracy sample inventories. The DDC guidance provides detailed instructions on the point of sampling (population), determining sample sizes, random sampling methodology, acceptable quality rate, and reporting of results. The DDC guidance requires that a sample of stock numbers be selected from the DSS PE4D - Completed Inventory Report. A chart is provided showing the required quality check sample size based on the overall population (lot size) of items inventoried by the contractor. The sample selection variable is determined by dividing the lot size by the sample size (for example, if the variable is 6 a random starting point on the PE4D report should be determined and every 6th item selected until the overall sample size is reached). A DSS PIEC1 - Inventory Evaluation and Research Listing Report should be obtained for each stock number to identify the results of the contractor counts at all locations. The quantities at each location are required to be physical verified by depot personnel to ensure that the contractor's physical count recorded accurate information. The acceptable quality rate is 99 percent. Subsequent sample sizes can be adjusted based on the acceptable quality rates over a three month period.

The DDC quality control guidance was not consistently implemented at three of the four Depots we visited. At DDCT, the responsible personnel stated that they had never seen the DDC guidance on quality control checks until the audit team arrived and provided a copy. At DDJC and DDSF, personnel informed us that the DDC guidance was confusing and that specific instructions had not been provided for the FY 2005 CFO sample inventories. In addition, depot personnel informed us that the DSS PE4D - Completed Inventory Report contained the results of all inventories, and not just the CFO sample inventories, making it voluminous and difficult to use for sampling purposes. We observed the following depot quality check practices:

- Observations of the contractor's third counts were included as part of the quality control sample rather than selecting stock numbers from the completed inventory report and performing post counts. While we believe it is beneficial to observe the contractor counts, these observations should supplement the quality check sample items rather than replace them.
- The lot size from the August 2005 record accuracy sample was used as a basis for determining the quality control sample size for the FY 2005 CFO sample. This resulted in an insufficient quality check sample size because the FY 2005 CFO sample contained twice as many overall items to be inventoried.
- Individual completed locations were selected for review instead of all locations for completed stock numbers.
- The methodology recommended by DDC to randomly select stock numbers for quality control checks was not always used. Instead, stock numbers were judgmentally selected for review based on warehouse location.

---

### **Attachment**

Our review of the DDC quality control check guidance identified the following areas that require additional clarification:

- The timing is not specified as to when the quality check sample should be selected and executed during the overall inventory process
- The office or individuals responsible for implementing the quality check guidance are not specifically identified.
- The acceptable quality rate over a three month period is required to be analyzed and the quality check sample size adjusted accordingly. This is confusing because the two primary sampling plans are not performed on a monthly basis. The CFO sample is performed annually and the record accuracy sample is performed semi-annually.
- The sampling plan(s) for which the quality check guidance should be applied is not specified. The instructions on reporting in the version provided to us cites the 2nd quarter FY 2005 sample inventory. However, the guidance was issued in preparation for the 4th quarter FY 2005 sample inventory.
- Instructions are not provided to immediately address situations where the acceptable quality rate is not met. Although larger quality check sample sizes are required after three months of unacceptable quality rates, poor contractor performance should be dealt with immediately. In addition, unacceptable quality rates can jeopardize the integrity of the statistical sample results. Quality check samples should be expanded at the time acceptable quality rates are not met rather than three months later.

Proper quality control checks are integral to assuring that the contractor is meeting the performance measures required by the contract. Inconsistent and insufficient quality checks increase the risk of inaccurate inventory counts going undetected.

#### General Warehousing Practices

We performed a limited test of controls to determine if the information for specific stock locations was properly recorded in DSS. We selected at least 45 locations at each depot and traced the item information back to DSS. An unusually large number of errors were identified at two depots. Specifically, 5 of 45 items failed our review at DDOO and 4 out of 57 items failed our review at DDCT. These error rates are unusually high compared to the other two depots where only 1 error was identified out of 126 locations reviewed.



**DEFENSE LOGISTICS AGENCY**  
DEFENSE DISTRIBUTION CENTER  
2001 MISSION DRIVE  
NEW CUMBERLAND, PA 17070-5000

IN REPLY  
REFER TO

DDC IR

DEC 13 2005

MEMORANDUM FOR DLA J-308

SUBJECT: Audit of the Internal Controls Over Inventory Stored at Defense Logistics Agency Distribution Depots (Project No. D2005-D00FJ-0266)

Attached are our comments to the control deficiencies identified by the DoDIG in their November 14, 2005, Memorandum, subject as above. These comments should reach the DoDIG by December 14, 2005, for inclusion in their formal report.

  
PHYLLIS C. CAMPBELL  
Deputy Commander

Attachment



DEFENSE LOGISTICS AGENCY  
DEFENSE DISTRIBUTION CENTER  
2001 MISSION DRIVE  
NEW CUMBERLAND, PA 17070-5000

IN REPLY  
REFER TO

DDC-J-3/J4-T

DEC 9 2005

MEMORANDUM FOR DDC-IR

SUBJECT: DoDIG Audit of Internal Controls Over Inventory Stored at DLA Distribution Depots

The Department of Defense Inspector General (DoDIG) is conducting an audit over the internal controls of inventory stored at DLA Distribution Depots. DDC stores material at twenty six distribution centers worldwide. The distribution centers are staffed by government employees, contractor personnel and government-operated Most Efficient Organizations (MEO) depending on results of A-76 competitions. Twenty-five of the twenty-six distribution centers use the Distribution Standard System (DSS) as the warehouse management software system and accountable record for material in storage. The on-hand balance of material on the shelf should match the quantity on record in DSS. Four distribution centers were selected to conduct a special inventory of DLA owned material for the Chief Financial Officers Act during the month of September 2005 (Type Physical Inventory Code (TPIC) L). During the TPIC L, DoDIG sent auditors to the four distribution centers to observe the execution of the inventory. This memorandum is in response to the DoDIG observations.

**General Comments:** The material to be inventoried is pulled from a random sample program that DORRA has developed with DoDIG approval of the methodology. The distribution centers and material that will be inventoried are not known until the sample is pulled and dropped into the DSS workload. Any of the distribution centers could have material selected to inventory from the program. DDC has contracted with Tessada and Associates to conduct the physical inventory counts. Tessada has personnel hired and on standby in cities located close to the distribution centers. Due to the randomness of the sample and virtually no lead time for planning at specific sites, all distribution centers and Tessada are on standby and ready to work if selected. During the September 2005 TPIC L, the four distribution centers selected as part of the sample were Defense Depot San Joaquin California (DDJC), Defense Depot Susquehanna Pennsylvania (DDSP), the Defense Depot Oklahoma City Oklahoma (DDOO), and the Defense Depot Corpus Christi Texas (DDCT).

Audit observations are addressed as follows:

**Audit Observation 1:** Contractor Physical Count Procedures

---

**Condition:** Contractor personnel did not consistently use Radio Frequency (RF) devices at DDJC and DDOO.

**DDC Comments:** Standard operating procedure is to use RF device to conduct a physical inventory count when the RF capability is available and in operating condition. DDC will reinforce this mandate before the February performance sample inventory. Use of RF can prevent errors due to in float transactions that occur during the inventory.

**Audit Observation 2:** Contractor Access to Location Quantities

**Condition:** DDC developed a counter profile to allow personnel conducting inventory counts the ability to input counts into DSS but restrict access to DSS programs that would be detrimental to the integrity of the sample inventory process. Elimination of access to the DSS quantity by location (QBL) was removed to prevent what is called a QBL count, which is taking the inventory balance on record and inputting it to the count screen without doing an actual physical count.

**DDC Comment:** DDC standard operating procedures strictly prohibit the use of QBL counts during a physical inventory. Tessada site managers are trained on this concept and, they in turn train and provide oversight so that the counters do not use the QBL to count. It was noted in the observations that no person was witnessed using QBL counts but when asked to access the QBL screen by auditors it was available. DDC code J-6 personnel did create a counter profile as a fail safe to maintain integrity of the overall inventory process. DDC collected the userids of all contractor personnel that would conduct counts and built a limited access profile for them to prevent QBL counts. When notified by DODIG auditors that the counter profile was not working in the production environment, DDC traced the glitch to the profiles being loaded at the mega-centers. DDC will meet with the J-6 technical personnel to evaluate the methodology used to create the profile, do a system trace analysis, and test to insure the profile will work in production. DDC plans to have the counter profile operational for the February performance sample inventory (TPIC N).

**Audit Observation 3:** Depot Quality Control Procedures

**Condition:** The DDC quality control guidance was not consistently implemented at three of the four depots DODIG visited and DODIG identified guidance areas that require additional clarification.

**DDC Comment:** DDC concurs that guidance was not consistently implemented and the need for clarification of the guidance to the distribution center exists. DDC is currently drafting new guidance that will be sent to the distribution centers before the February TPIC N inventory. In addition to the guidance, VTC's will be held with the Distribution Center Accountable Officers to review the guidance. Special guidance for future TPIC L's will be drafted and sent in advance of the inventory. DDC realizes the quality control checks are integral to insuring the contractor or government personnel performing performance-type

inventories are meeting standard quality goals which solidify the integrity of the overall inventory control program.

**Audit Observation 4:** General Warehousing Practices

**Condition:** DODIG auditors conducted a limited test of controls to determine if the information for specific stock locations was properly recorded in DSS. The test at DDOO concluded that 5 out of 45 items failed the review and at DDCT 4 out of 57 items failed the review.

**DDC Comment:** As part of the DDC Swarm initiative, Warehousing training has been developed. The training course consists of a top quality participant's guide and formal training that is given by Interactive Video Training (IVT) or live classroom training. Initial training via IVT started for warehousing in mid-October, and to date approximately 1,000 personnel DDC wide have completed the course. This course explains proper warehousing procedures, policy, and also technical "how to" in DSS. Also, each distribution center is required to do a location survey at 100% of locations within a 12 month period, either through a sample or wall-to-wall process, coinciding with the federal fiscal year. Location surveys are intended to correct discrepancies between location data and DSS. Inventory personnel conducting location surveys have also been trained as part of the Swarm initiative. The location survey and item data units are part of the Inventory Control Swarm training program.



JANET CRAVENER  
Chief, Logistics Policy Division

# Appendix C. March 2006 Interim Results Memorandum and DLA Response



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
OFFICE OF THE ASSISTANT INSPECTOR GENERAL FOR AUDITING  
630 MORRISON ROAD, SUITE 310  
GAHANNA, OH 43230-5327



March 8, 2006

MEMORANDUM FOR COMMANDER, DEFENSE DISTRIBUTION CENTER

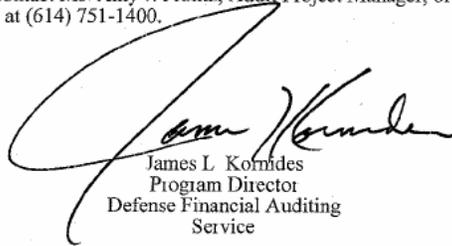
SUBJECT: Audit of the Internal Controls Over Inventory Stored at Defense Logistics Agency  
Distribution Depots (Project No. D2005-D000FJ-0266)

As part of the second phase of our audit we are reviewing the execution of the February 2006 Defense Logistics Agency Inventory Record Accuracy Sampling Plan. During our site visit to the Defense Depot Anniston Alabama (DDAA) on February 14th-17th, 2006, we identified issues involving improper storage practices that require immediate management attention.

The DoDIG auditor performing the site visit, Mr. Brian Henry, coordinated with the DDAA security officer to have pictures taken to document poor warehouse conditions. These pictures are included as an attachment to this memorandum and on the enclosed compact disk. The pictures identify a number of potential safety issues and damaged stock. In addition, a floor-to-record test of 50 locations identified 21 instances where the stock information for a given location was improperly recorded in the Distribution Standard System. Due to time constraints only 15 warehouses were reviewed, which represent approximately half of the total DDAA warehouses.

We are providing this interim information to allow for timely corrective actions. At a minimum, the corrective actions should include safety inspections as well as location surveys, inventories, and condition inspections of potentially damaged material in all DDAA warehouses. Once our remaining field work is completed we will issue a formal audit report, which will incorporate this memorandum and any corrective actions taken. We request that a response be provided within 30 days and describe the actions taken or planned in response to this memorandum.

If you have any questions or need additional information regarding this memorandum or the attached pictures, please contact Ms. Amy J. Frontz, Audit Project Manager, or Mr. Anthony C. Hans, Audit Team Leader, at (614) 751-1400.

  
James L. Kornides  
Program Director  
Defense Financial Auditing  
Service

ATTACHMENT

ATTACHMENT



ATTACHMENT



ATTACHMENT



ATTACHMENT



ATTACHMENT



ATTACHMENT





**DEFENSE LOGISTICS AGENCY**  
DEFENSE DISTRIBUTION CENTER  
2001 MISSION DRIVE  
NEW CUMBERLAND, PA 17070-5000

IN REPLY  
REFER TO

DDC IR

April 6, 2006

MEMORANDUM FOR DLA J-308

SUBJECT: Audit of the Internal Controls Over Inventory Stored at Defense Logistics  
Agency Distribution Depots (Project No. D2005-D000FJ-0266)

Attached is the DDC's reply to DoDIG memorandum dated March 8, 2006,  
subject as above. Response due date to DoDIG is April 7, 2006.

Craig L. Mayer, Audit Director, Office of Internal Review, is the POC for this  
audit. His telephone number is (717) 770-6213, or email [craig.mayer@dla.mil](mailto:craig.mayer@dla.mil).

  
EDWARD R. VISKER  
Colonel, USA  
Chief of Staff

Attachment



**DEFENSE LOGISTICS AGENCY**  
DEFENSE DISTRIBUTION CENTER  
2001 MISSION DRIVE  
NEW CUMBERLAND, PA 17070-5000

IN REPLY  
REFER TO

DDC J-3/J-4-TP

APR 4 2006

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE,  
OFFICE OF THE ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Audit of the Internal Controls Over Inventory Stored at Defense Logistics  
Agency Distribution Depots (Project No. D2005-D000FJ-0266)

This memorandum is the DDC response to DoDIG memorandum dated March 8, 2006 in which DoDIG Auditor, Mr. Brian Henry, identified issues involving improper storage practices while observing the DDC random sample inventory at Defense Depot Anniston Alabama on February 14-17, 2006. We appreciate the opportunity to outline the actions that are being taken in response to the pictures that identify possible damaged stock, safety issues, and the results of your floor-to-record test of 50 locations in which 21 of the locations identified that stock information recorded in DSS did not match what was actually in location.

During Mr. Henry's in-brief, LTC Harney, DDAA Commander, informed him of the plan of actions that are currently underway at DDAA due to a Whistleblower complaint on care of material in storage. Mr. Henry subsequently took pictures of the conditions discussed and re-stated in his report the challenges discussed. The initial investigation on the Whistleblower complaint occurred in August 2005 and was responded to under Office of Special Council File No. DI-05-1839. During both the in-brief and out-brief, the DDAA Commander reviewed with Mr. Henry the get well plan in place to correct noted deficiencies.

DDC and DDAA leadership are aware of the current warehousing deficiencies that were identified by OSC and DoDIG and at the direction of the Commander, Defense Distribution Center, three DDC staff members visited DDAA during mid September 2005 to investigate the findings. A summary of their findings confirmed the allegations that materiel was not always stored or physically inspected in accordance with Defense Logistics Agency (DLA) regulations. The problems are not a result of deficiencies with DLA regulations but rather a lack of DDAA management following through on proper procedures. DDC and DDAA have taken actions to correct the immediate deficiencies outlined by the whistleblower and further developed plans of actions that address the entire scope to deficiency in proper care of supplies in storage (COSIS). Those same deficiencies were identified in your audit in February 2006.

As stated, the plan started in the Fall of 2005 but not all areas have been completed. The DDAA Commander is closely monitoring the oversight provided by the managers and supervisors at DDAA as the get well plan continues. The following

---

actions have been completed or are on-going since the Fall of 2005 to ensure the approximate 30,000 NSNs in storage are stored and handled in accordance with DLA regulations.

1. A 100% inspection conducted on all items stored in location for proper packaging and preservation.
2. Properly packaging items in accordance with DLA regulations.
3. Re-training of proper policy and DSS procedures for members of the DDAA workforce involved in the receiving, packaging, inspection and care of supplies in storage.
4. Collateral duties have been removed from DDAA's Stock Readiness Specialist and he is assigned full time to COSIS/Stock Readiness duties.
5. Stock Readiness/COSIS standard operating procedures updated and processes reviewed for compliance with stock readiness requirements. Process mapping of all operating procedures included establishment of appropriate points for quality checks.
6. Performed a complete survey of all delinquent stock readiness/COSIS actions and prepared/submitted surveillance discrepancy reports, DD Form 1225, to service owners for disposition action (DDAA must wait for disposition instructions from the service). Providing a monthly update to DDC Logistics Operations.
7. Inspected 100% of all material returned to storage from military services as required by DLA regulation.
8. Scheduled and conducting 100% Location Surveys (to be completed by 30 September 2006).
9. Survey will include identification for action appropriate re-warehousing and location marking. (On-going)
10. Improved leadership accountability; updated performance standards and leader, supervisor, and workforce counseling on those standards to ensure compliance.
11. DDAA Commander implemented adverse action against applicable supervisors.
12. Process mapping and standard operating procedures development/revision, with quality checks included for long term sustainment correct processing.

In addition, the following action has been taken on potential safety issues.

1. DDC Health and Safety audit was conducted 13-17 March 2006. Mr. Rod Petri, Safety Auditor, was made aware of deficiencies and the get well plan of actions. He inspected all warehouses in question. Interim feedback from Mr. Petri indicates minimal safety issues, most of which were on the spot corrections. He will submit a formal report with pictures to the DDC Safety Office upon audit conclusion.
2. General Warehouse clean-up. (Estimated completion date is 30 June 2006).

---

DDC and DDAA management have taken all noted investigation and audit findings very serious and have a plan to correct deficiencies in place and continue to track progress with completion during FY06.

If you have any questions or need additional information regarding this memorandum please contact Mr. Christian Lubic, DDC Inventory Integrity Program Manager.



JANET CRAVENER  
Chief, Logistics Policy Division

---

## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
Director, Acquisition Resources and Analysis  
Under Secretary of Defense (Comptroller)/Chief Financial Officer  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Director, Program Analysis and Evaluation

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

Auditor General, Department of the Air Force

### **Combatant Command**

Inspector General, U.S. Joint Forces Command

### **Other Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Contract Management Agency  
Director, Defense Finance and Accounting Service  
Director, Defense Intelligence Agency  
Director, Defense Logistics Agency  
Director, National Security Agency  
Director, Defense Systems Management College

### **Non-Defense Federal Organizations and Individuals**

Office of Management and Budget

---

## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations

Senate Subcommittee on Defense, Committee on Appropriations

Senate Committee on Armed Services

Senate Committee on Homeland Security and Governmental Affairs

House Committee on Appropriations

House Subcommittee on Defense, Committee on Appropriations

House Committee on Armed Services

House Committee on Government Reform

House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform

House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform

House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform



# Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY  
HEADQUARTERS  
8725 JOHN J. KINGMAN ROAD, SUITE 2533  
FORT BELVOIR, VIRGINIA 22060-6221

IN REPLY  
REFER TO J-308

OCT 03 2006

MEMORANDUM FOR THE DEPUTY INSPECTOR GENERAL FOR AUDITING,  
DEPARTMENT OF DEFENSE

Subject: Draft Report on the Internal Controls Over Inventory Stored at Defense  
Logistics Agency Distribution Depots, D2005FJ-0266

The subject draft report has been reviewed and management concurs with the findings and is providing comments to the recommendations listed in the report. Should you have any questions the Internal Review point of contact is Ms. Sharon Nelson, 703-767-6267.

  
BENNIE E. WILLIAMS  
Major General, USA  
Director, Logistics Operations

Attachment

cc:  
DDC  
J-37

---

SUBJECT: Audit of Internal Controls over Inventory Stored at Defense Logistics  
Agency Distribution Depot, D2005FJ-0266

**General Comments:** The report is overall very complimentary of the progress made by DDC in inventory controls and performance. The audit was conducted while the Swarm inventory improvement project was in progress at the DDC distribution centers. The Swarm program, started in second quarter of fiscal year 2003 includes intensive training, distribution center physical location and record balance clean-up, and systems improvements. The objective of Swarm is to improve the integrity of the accountable record, meet inventory accuracy goals and establish the materiel owner's trust in DLA/DDC's custodial responsibility. As of August 30, 2006, DDC posted its best level of inventory accuracy in history as measured by DoD MILSTRAP goals. Eighteen of the twenty-six distribution centers met all measurable goals during the August 2006 performance inventory. DDC overall met goal in every category.

**Recommendation 1:** Require that all contractor and Government personnel responsible for operating the distribution depots complete sufficient training and comply with inventory accuracy requirements for physical inventory counts, storage practices, discrepancies research, and quality checks. Adverse actions should be taken against supervisors who consistently fail to comply with established policy.

**Comments:** Concur in concept and have the processes and programs in place for compliance.

The DDC has developed recurring training program that focuses on the four processes and transactions that impact the accountable balance. The training courses cover the subjects of Receiving, Warehousing, Inventory Control, and Stock Readiness. Since the courses have been developed and implemented across the distribution centers as part of the Swarm program, over 3000 employees have been trained and certified.

The Inventory Control Swarm Training specifically addresses the requirements for conducting physical inventory counts and discrepancy research. As a note, the audit finding indicated less than 1% error in the count processes and remarked on the significant progress made since the initial audit. The Stock Readiness and Warehousing Swarm Training cover the requirements for storage practices. For quality checks (QC) of the Logistical Sample Performance inventory and the CFO inventory, training and procedures are provided to each distribution center Accountable Officer (AO) before the inventory commences.

All employees have a performance standard with a specific critical element of accountability and quality for the processes they perform. Errors that are found can be traced back to the employee by userid in the Distribution Standard System. Employees are retrained and advised of potential disciplinary action for continued errors. Records indicate that with the training reinforcement employees are making fewer initial errors.

---

DDC Logistics division is currently reorganizing and includes a newly established policy division. To further insure compliancy by management and the workforce, this division will have oversight of quality checks for distribution performance

**Recommendation 2:** Use the revised quality check process to enforce the 99-percent accuracy requirement for contractor-performed inventory counts, and apply the appropriate penalties for any shortfalls.

**Comments:** **Concur;** DDC has taken steps to tighten control of the quality check process after this audit identified shortfalls in the interim report and will continue to use the revised process. Future contracts for inventory counting will include both positive and negative incentives.

**Recommendation 3:** Establish a standardized methodology to appropriately penalize contractor and Government operated depots that consistently fail to meet inventory-related performance measures, particularly those depots that have completed public-private competition required by Office of Management and Budget Circular A-76.

**Response to Recommendation 3:** **Concur;** the DDC Contracting Office is working to enhance future contracts to include both positive and negative incentives as well as an award fee for meeting inventory integrity performance indicators. In addition, various options are being explored that will strengthen and provide focus on the materiel support type functions such as Inventory. These include, but are not limited to, a new Contract Line Item Number (CLIN) structure breakout for separate payment for performance of physical inventories, location surveys and stock readiness surveillance inspections. Currently, DDC Contracting tracks performance indicators and follows contracting law and procedure in working with contracted distribution centers when performance falls below performance levels that are required by the contract. The DDC Logistics Operations Directorate monitors MEO government-operated sites for adherence to established Acceptable Performance Levels (APL) and regulations. Although financial penalties are not realistic for an MEO, the DLA Internal Review Office performs an in-depth assessment of each MEO operation one year following standup to ensure adherence to the requirements outlined in the Performance Work Statement (PWS). MEO sites are subject to the same option year approval process and failure to meet the APLs would impact their standing as a high performing activity qualifying for option years.

**Recommendation 4:** Establish a process for an independent review of the inventory valuation statistical sampling plan results to ensure that the proper values and spreadsheet references are used in the statistical calculations.

**Comments:** **Concur.** The DLA Office of Operations Research and Resource Analysis (DORRA) will continue to conduct an in-house peer review of the inventory valuation statistical sampling plan results to validate the design, criteria and calculations. In addition, HQ DLA J-37 has coordinated with the Department of Defense Inspector General (DoD IG) to conduct an independent review of the inventory valuation sampling plan results. The spreadsheet will be forwarded to the DoD IG statistician on an annual

---

Page 2

Subject: Audit of Internal Controls over Inventory Stored at DLA Distribution Depots

basis during the last week of August for the independent review. It is imperative that DORRA sends the population sample to the DDDC during the first week of September in order to have ample time to complete the inventory; therefore, DLA is firmly committed to meeting the established sampling time frame. If discrepancies are identified by the DoD IG statistician, adjustments will be made as warranted.

**Manager's Internal Control Program:** The Physical Inventory Control Program is evaluated annually via the DLA Management Control Program. Various efforts such as policy updates, systems changes/upgrades and the Swarm initiative have been implemented, resulting in enhanced controls over inventory stored at the distribution depots. It is worthy to note that the Swarm initiative had the most impact on improving physical inventory controls. Swarm is a two-fold effort that was launched during the second quarter of fiscal year 2003. It began with a DDC led massive clean-up effort of all depots along with the development of comprehensive training modules for the areas of the distribution process that impact the accountable record. The success of Swarm is evident in the inventory accuracy metrics, depot personnel training, and system enhancements. This current effort is an all-encompassing, rationally planned, enterprise-wide effort to ensure the continued ability to maintain levels of accuracy and efficiency in the future. We will continue to assess the effectiveness of internal controls and report in accordance with DoD 5010.40, Managers' Internal Management Control Program Procedures.

## **Team Members**

The Department of Defense Office of the Deputy Inspector General for Auditing, Defense Financial Auditing Service prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

Paul J. Granetto  
Amy J. Frontz  
Anthony C. Hans  
Kevin C. Currier  
James C. Darrough  
Brian L. Henry  
Brian M. Stumpo  
Bethany L. Hartman  
Lusk F. Penn  
Catherine Bird