Audit Report

VALUATION AND PRESENTATION OF INACTIVE INVENTORY ON THE FY 1997 DEFENSE LOGISTICS AGENCY WORKING CAPITAL FUND FINANCIAL STATEMENTS

Report Number 98-195 August 27, 1998

Office of the Inspector General
Department of Defense

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Acronyms

AAO	Approved Acquisition Objective
DLA	Defense Logistics Agency
GAO	General Accounting Office
ICP	Inventory Control Point
IG	Inspector General
WCF	Working Capital Fund

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August 27, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DEPUTY UNDER SECRETARY OF DEFENSE (LOGISTICS)
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Valuation and Presentation of Inactive Inventory on the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements (Report No. 98-195)

We are providing this report for review and comments. This is the third in a series of reports dealing with the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements. In preparing the final report, we considered comments from the Under Secretary of Defense (Comptroller), the Deputy Under Secretary of Defense (Logistics), and the Director of the Defense Logistics Agency on the draft of this report.

DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. We considered the comments from the Deputy Under Secretary of Defense (Logistics) and the Under Secretary of Defense (Comptroller) to be nonresponsive; therefore, we request additional comments on the recommendations by October 26, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. James L. Kornides, Audit Program Director, at (614) 751-1400, extension 11, e-mail jkornides@DODIG.OSD.MIL; or Mr. Timothy F. Soltis, Audit Project Manager, at (614) 751-1400, extension 13, e-mail tsoltis@DODIG.OSD.MIL. See Appendix D for the report distribution. The audit team members are listed inside the back cover.

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Report No. 98-195 **August 27, 1998**
(Project No. 8FJ-2002.02)

Valuation and Presentation of Inactive Inventory on the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements

Executive Summary

Introduction. The audit was performed to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," as amended by Public Law 103-356, the "Federal Financial Management Act of 1994." This is the third in a series of reports on the FY 1997 Financial Statements of the Defense Logistics Agency (DLA) Working Capital Fund (WCF). The first report, "Internal Controls and Compliance with Laws and Regulations for the FY 1997 Financial Statements of the DLA WCF" (Report No. 98-148), was our disclaimer of opinion on the financial statements and our evaluation of management's internal control program and compliance with applicable laws and regulations. The second report, "Audit of Military Department Materiel Returns to the DLA Distribution Depots" (Report No. 98-179), dealt with unauthorized returns of materiel from Military Department field organizations to the DLA distribution depots. See Appendix B for a summary of prior audit coverage.

The DLA Working Capital Fund finances six business areas whose primary function is to provide logistics support to DoD and other authorized customers. Inventory is the largest asset account on the financial statements. Inventory, Net, was reported at $9.8 billion (82 percent of total assets) on the FY 1997 Consolidated Statement of Financial Position of the DLA Working Capital Fund. The $9.8 billion included $3.1 billion of inactive inventory (32 percent of the total inventory). Inactive inventory consists of stock retained for economic or contingency reasons and for potential reutilization and disposal.

The General Accounting Office reported that DoD management of secondary inventory was a high-risk area in FY 1997 and previous fiscal years. One of the primary management deficiencies was that the DoD Components (the Military Departments and DLA) maintained high levels of unneeded inventory. The General Accounting Office concluded that all inactive inventories were unneeded because they exceeded the stock levels that DoD established for war reserves and current operations.

Audit Objectives. The overall objective of our audit was to determine whether the FY 1997 Financial Statements of the DLA Working Capital Fund were presented fairly and in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. For this part of the audit, we reviewed the valuation and presentation of inactive inventory in the financial statements. We did not review the internal control program as it related to the audit objective because it was addressed in our report on internal controls and compliance with laws and regulations. See Appendix A for a complete discussion of the scope and methodology and Appendix B for a summary of prior coverage.

Audit Results. DLA followed DoD accounting policy for valuing inactive inventory. However, the DoD policy was not adequate to ensure that the value of stocks retained for economic and contingency reasons, as reported on the DLA Working Capital Fund financial statements, reflected their uncertain future utility (revenue-producing ability). As a result, the $9.8 billion reported on the financial statements as Inventory, Net, was overstated by as much as $3 billion, and related inventory expense accounts were understated by the same amount (Finding A).

Inactive inventory was not correctly presented and disclosed in the financial statements of the DLA Working Capital Fund. As a result, the financial statements did not provide complete and accurate data on two categories of the Inventory, Net, account: Inventory Held for Current Sale and Excess, Obsolete, and Unserviceable Inventory (Finding B).

The recommendations in this report, if implemented, will improve the reliability and usefulness of the financial statements. See Part I for a discussion of the audit results.

Summary of Recommendations. We recommended that the Deputy Under Secretary of Defense (Logistics) evaluate the methodology used to compute the net realizable value of stock and determine the appropriate rate for valuing stocks retained for economic and contingency reasons. We recommended that the Under Secretary of Defense (Comptroller) amend the DoD accounting policy to require that stocks retained by the DoD Components for economic and contingency reasons be shown on the financial statements as Excess, Obsolete, and Unserviceable Inventory and valued at their net realizable value. We recommended that the Director, DLA, present all inactive inventory as Excess, Obsolete, and Unserviceable Inventory on the DLA Financial Statements, and disclose how DLA identified and valued those stocks.

Management Comments. The Deputy Under Secretary of Defense (Logistics) disagreed and stated that calculated probabilities show that the stock will be sold in the future. The Office of the Under Secretary of Defense (Comptroller) also disagreed and stated that the existing DoD accounting policy is consistent with Statement of Federal Financial Accounting Standards No. 3. The Defense Logistics Agency agreed to comply with DoD accounting policies regarding the valuation and presentation of retention stocks on the financial statements. See Part I for a discussion of management comments and Part III for the complete text of management comments.

Audit Response. We disagree with the responses from the Deputy Under Secretary of Defense (Logistics) and the office of Under Secretary of Defense (Comptroller). See Part I for our detailed audit response to their comments. We request that the Deputy Under Secretary of Defense (Logistics) and the Under Secretary of Defense (Comptroller) reconsider their position and provide comments to include studies showing the probability that retention stocks will be sold within the 6-year retention period. Comments are requested by October 26, 1998.

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Part I - Audit Results

Audit Background

Introduction. The audit was performed as part of our effort to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. This is one of a series of reports on the financial statements of the Defense Logistics Agency (DLA) Working Capital Fund (WCF). The first report, "Internal Controls and Compliance with Laws and Regulations for the FY 1997 Financial Statements of the DLA WCF" (Report No. 98-148), was our disclaimer of opinion on the FY 1997 Financial Statements of the DLA WCF. The second report, "Military Department Materiel Returns to the DLA Distribution Depots" (Report No. 98-179), discussed unauthorized returns of materiel from Military Department field organizations to the DLA distribution depots. We also issued a report on internal controls and compliance with laws and regulations.

DLA Working Capital Fund. The DLA WCF finances six business areas* whose primary function is to provide logistics support to DoD and other authorized customers. Inventory is the largest asset account on the financial statements of the DLA WCF. Inventory, Net, was reported at $9.8 billion (82 percent of total assets) on the FY 1997 Consolidated Statement of Financial Position of the DLA WCF. The $9.8 billion represented the value of Inventory after adjustments for unserviceable and potential reutilization and disposal stock. Two business areas, Supply Management and Reutilization and Marketing, determine the value of inventory.

Supply Management. This business area consists of five DLA Inventory Control Points (ICPs) that buy consumable materiel and position it at storage locations, issue materiel to customers, and identify and dispose of the excess. To categorize the inventory managed by the ICPs, DLA uses a stratification process that applies the quantity of each item against its requirements in a prescribed priority and time sequence. Depending on the category, items are valued at latest acquisition price (using contract prices maintained in logistics records at the ICPs) or net realizable value (using rates established by the Principal Deputy Under Secretary of Defense for Logistics).

Reutilization and Marketing. This business area consists of about 150 Defense Reutilization and Marketing Offices that sell, reutilize, transfer, donate, or otherwise dispose of excess DoD property. Based on sales data from the Defense Reutilization and Marketing Service, the Office of the Principal Deputy Under Secretary of Defense (Logistics) computes the percentage used to reduce the value of DoD inventory from its latest acquisition cost to net realizable value. In FY 1997, the rate for net realizable value was established at 2.7 percent of latest acquisition cost.

Composition of DLA Inventory. DLA categorized its FY 1997 year-end inventory as active and inactive inventory.

*The six DLA business areas are: Supply Management, Distribution Depots, Reutilization and Marketing, Industrial Plant Equipment, Information Services, and the Defense Automated Printing Service.

Active Inventory. The active inventory consists of materiel that is expected to be consumed within a 2-year period (the DoD budget cycle) and includes stock levels that fall within the Approved Acquisition Objective (AAO) for DoD. The AAO represents the inventory needed to equip and sustain U.S. and allied forces in accordance with current DoD policies and plans. The AAO includes stock levels to cover war reserves and minimum quantities for designated items. The AAO also includes outstanding back orders, demands expected after the date that a need for an item is identified and before the item is received, and minor interruptions in the supply process or unpredictable fluctuations in demand. At the end of FY 1997, DLA records showed $6.7 billion of active inventory.

Inactive Inventory. Inactive inventory is materiel that is not expected to be consumed within the 2-year budget period. It includes inventory retained for economic and contingency reasons and for potential reutilization and disposal. At the end of FY 1997, DLA records showed $4.9 billion of inactive inventory at latest acquisition value. The value of inactive inventory included in the financial statements was $3.1 billion, which reflected the latest acquisition cost of stock retained for economic and contingency reasons and the net realizable value of potential reutilization and disposal stock.

Economic retention stock is inventory that exceeds the AAO, but for which the ICP has determined that it is more economical to retain the items for future use than to dispose of them.

Contingency retention stock is inventory that exceeds the level of stock retained for economic reasons and for which there is no predictable demand or quantifiable requirement. This stock is retained for contingency purposes.

Potential reutilization and disposal stock is inventory that exceeds the levels of stock retained for economic and contingency reasons. The ICPs have determined that items in this category are not needed. These items will probably be disposed of through the Defense Reutilization and Marketing Service.

Audit Objectives

The overall objective of our audit was to determine whether the FY 1997 Financial Statements of the DLA WCF were presented fairly and in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. For this part of the audit, we reviewed the valuation and presentation of inactive inventory in the financial statements. We did not review the internal control program as it related to the audit objective because it was addressed in our report on internal controls and compliance with laws and regulations. See Appendix A for a complete discussion of the scope and methodology and Appendix B for a summary of prior audit coverage.

Finding A. Valuation of Inactive Inventory Retained for Economic and Contingency Reasons

DLA followed DoD accounting policy for valuing inactive inventory. However, the DoD policy was not adequate to ensure that the value of stocks retained for economic and contingency reasons, as reported on the DLA WCF financial statements, reflected the uncertain future utility of those stocks. As a result, the $9.8 billion reported on the financial statements as Inventory, Net, was overstated by as much as $3 billion, and related inventory expense accounts were understated by the same amount.

Policy for Valuation of Inventory

Federal Government Accounting Policy. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," was issued by the Federal Accounting Standards Advisory Board on October 27, 1993. Accounting Standard No. 3 established the policy on inventory valuation for Federal Government entities, stating that inventory should be valued at latest acquisition cost or historical cost, except for Excess, Obsolete, and Unserviceable Inventory, which should be valued at its net realizable value. Accounting Standard No. 3 defines excess inventory as inventory that exceeds demands expected to occur during the normal course of operations. The difference between the latest acquisition cost of the excess inventory and its net realizable value shall be recognized as a loss in the period in which the value is reduced.

DoD Accounting Policy. DoD Regulation 7000.14-R (the Regulation), the "DoD Financial Management Regulation," volume 11B, chapter 55, December 1994, establishes the accounting policy that DoD Components are to use in reporting inventory balances on their financial statements. The Regulation states that active inventory reported on the financial statements should be valued at its latest acquisition cost, applying the last representative price to all like items. Also, inactive inventory retained for economic and contingency reasons should be presented as Inventory Held for Future Sale and valued at its latest acquisition cost. The Regulation also requires that inactive inventory categorized as potential reutilization and disposal stock be shown on the financial statements as Excess, Obsolete, and Unserviceable Inventory and valued at its net realizable value. Based on sales data from the Defense Reutilization and Marketing Service, the Office of the Principal Deputy Under Secretary of Defense (Logistics) annually computes the rate used to determine net realizable value.

Inactive Inventory

DLA prepared summary reports showing that as of September 30, 1997, the inactive portion of its WCF inventory was valued at $4.9 billion, the latest acquisition cost. The inactive inventory consisted of $2.9 billion of stock retained for economic reasons, $.16 billion retained for contingencies, and $1.8 billion retained for potential reutilization or disposal.

Purchasing Inactive Stock. DLA did not intentionally purchase the $4.9 billion of inactive inventory. DoD Regulation 4140.1-R, the "DoD Materiel Management Regulation," January 1993, generally prohibits DoD Components (the Military Departments and DLA) from purchasing materiel that exceeds the AAO, which represents supplies that should be adequate for the next 2 years. The inactive inventory was accumulated when anticipated requirements did not occur because of reductions in the force structure and other factors. In addition, some of the inactive DLA inventory was accumulated as a result of the Consumable Item Transfer Program, which was established in July 1990 to transfer the management of consumable items from the Military Departments to DLA.

Retaining Inactive Stock. DoD policy allows some inactive inventory to be retained for economic or contingency reasons. DoD Regulation 4140.1-R allows the DoD Components to establish their own retention levels. DLA, which has a 6-year economic retention period, has determined that it is more economical to retain items that are expected to be consumed within 6 years (the 2-year AAO plus an additional 4 years) than to dispose of these items. Materiel may be retained beyond the 6-year period if the ICP determines that a need exists to meet a specific contingency.

Adequacy of DoD Accounting Policy

DLA complied with DoD accounting policy by valuing the $3.1 billion of retention stocks ($2.9 billion retained for economic reasons and $.16 billion for contingencies) at their latest acquisition cost. DLA also complied with DoD policy by valuing the $1.8 billion of stock retained for potential reutilization and disposal at its net realizable value.

DoD accounting policy is adequate for valuing the portion of inactive inventory categorized as reutilization and disposal stock. However, the policy is not adequate for valuing the portion of inactive inventory that is retained for economic and contingency reasons. To justify valuing inventory retained for economic and contingency reasons at latest acquisition cost, DLA would have to show that the items are as likely to be sold as active inventory.

Valuation of Economic and Contingency Stock

DoD policy for stock retained for economic and contingency reasons, which allowed inventory to be valued at its latest acquisition cost, did not reflect the uncertainty of its future utility. Specifically, stocks retained for economic and contingency reasons are not expected to be consumed during the normal course of operations; therefore, they represent excess materiel as defined by Accounting Standard No. 3.

Normal Course of Operations. Accounting Standard No. 3 defines excess inventory as inventory that exceeds demands expected to occur during the normal course of operations. For the DLA WCF, the normal course of operations is the 2-year budget period. Generally, DoD Components should purchase only stock that falls within the Approved Acquisition Objective (AAO), which covers the 2-year budget period. Also, DoD has consistently defined "required inventory" as inventory that is projected to be used through the end of the budget year, and has used the same definition for both the budgeting and reporting of inventory.

The active portion of inventory represents a current asset on the Statement of Financial Position because that inventory is expected to result in a cash inflow to the ICP (through sales of materiel) within the normal operating or budget period. DLA also uses its active inventory to reduce future budget requests. Inactive inventory does not generally result in a cash flow to the ICP within the 2-year budget period and does not reduce future budget requests.

Excess Inventory. Although DoD policy allows DLA to retain stock for economic and contingency reasons, the materiel in those categories exceeds the stock level needed for the 2-year budget period.

The General Accounting Office (GAO) identified DoD management of secondary inventory as a high-risk area in FY 1997 and previous fiscal years. One reason was that DoD Components maintained high levels of unneeded inventory. According to GAO, about 50 percent of all DoD WCF inventory was not needed to satisfy current and war reserve requirements (the AAO). GAO classified all inactive inventory as unneeded. The GAO reports did not address the valuation of inactive inventory. However, for unneeded materiel, the most appropriate category in Accounting Standard No. 3 would be Excess, Obsolete, and Unserviceable Inventory.

In response to concerns about retaining large amounts of excess materiel, DoD set a goal of reducing inventory levels from $69 billion in FY 1996 to $52 billion by FY 2001. The projected reduction of $17 billion equals the total value of inactive inventory in FY 1996.

DLA established several programs at its ICPs and distribution depots to monitor and reduce inactive inventory levels and eliminate the associated costs of retaining inventory. Item managers at the ICPs must review items held for long periods and determine whether they should be disposed of. The Defense Inactive Item Program targets items that have not been requested in 5 years.

The Space Hog program requires the distribution depots to notify the ICPs of items that occupy significant storage space and have not been moved in 2 years. The necessity of these programs is further evidence of the uncertain future utility of inactive inventory.

Impact on the Financial Statements

Determining Net Realizable Value. Based on sales data from the Defense Reutilization and Marketing Service, the Office of the Principal Deputy Under Secretary of Defense (Logistics) determined that 2.7 percent of the latest Acquisition cost should be the net realizable value. All DoD Components were to use the 2.7 percent rate in preparing their FY 1997 financial statements.

The method of computing the net realizable value was established in October 1991, when DoD modified its procedures for preparing the Supply System Inventory Report. The method used to compute the net realizable value for the Supply System Inventory Report was incorporated into the method used to prepare the FY 1992 financial statements.

The DoD policy was intended for use only in valuing the portion of inactive inventory categorized as potential reutilization and disposal stock. It was not intended for use in valuing the portion of inactive inventory retained for economic and contingency reasons because those items were not destined for reutilization and disposal. However, carrying inactive inventory retained for economic and contingency reasons at full latest acquisition value is not reasonable. The items are not likely to be sold and are closer to potential reutilization and disposal stock than active inventory. Therefore, the method of computing net realizable value should be reevaluated to determine the most appropriate rate for valuing stocks retained for economic and contingency reasons.

Impact on the DLA WCF. If DLA had used the 2.7 percent rate for the $3.1 billion reported as the latest acquisition value of stocks retained for economic and contingency reasons, the value of those stocks would have been reduced to $83 million. Accounting Standard No. 3 requires that the difference between the latest acquisition cost of the inventory and the net realizable value be shown on the financial statements as a decrease in Inventory, Net, and an increase in Other Expenses. However, because much of the inactive stock accumulated in the past, any write-downs of stock retained for economic and contingency reasons should be shown as an adjustment to equity, rather than an expense.

Potential Effect on the Military Department WCF Financial Statements. Although we did not review the financial statements of the Military Department WCFs during this audit, the FY 1997 DoD Supply System Inventory Report indicated that the Military Departments retained about $10.6 billion of stocks for economic and contingency reasons. Because the Military Departments valued these stocks at latest acquisition cost in the FY 1997 financial statements of the WCFs, the value shown as Inventory, Net, was overstated.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Deputy Under Secretary of Defense (Logistics) evaluate the method used to compute the net realizable value and determine the appropriate rate for the valuation of stocks retained for economic and contingency reasons.

Management Comments. The Deputy Under Secretary of Defense (Logistics) did not agree that economic and contingency retention stocks should be valued at their net realizable value. The Deputy Under Secretary stated that economic retention stock is held based on a formula to balance the risk of paying for holding inventory already purchased against the risk of having to repurchase stock once disposed. There are calculated probabilities that stock will be sold in the future although there may be no present demand. Contingency retention stock is held for specific contingencies such as foreign military sales, for which there is a probability of future sale. The Deputy Under Secretary further stated that both the Inspector General (IG), DoD, and the General Accounting Office are incorrect in assessing that retention stock is not needed and therefore is excess.

Audit Response. We disagree with the response from the Deputy Under Secretary of Defense (Logistic). Retention stocks are best represented in the financial statements as Excess, Obsolete, and Unserviceable inventory and should be valued at net realizable value. DLA did not buy its inactive stock with the intent of selling it during the next 2 to 6 years. Rather, the inactive stock accumulated because of a lack of demand resulting from force structure reductions and other factors. Also, despite DoD initiatives to reduce inventory, the combined value of economic and contingency retention stock held by DLA has increased from $2.9 billion in FY 1996 to $3.1 billion in FY 1997, giving further evidence that the stock lacks the potential for future sales.

The Deputy Under Secretary should consider the fact that 80 percent of the DLA stocks retained for economic and contingency reasons are managed as non-demand-based items. DLA categorizes them as Numeric Stockage Objective items and defines them as "a class of items deemed to be critical insurance items which may exhibit a very limited historical demand or no demand whatsoever but because they are considered critical items, a non-demand-based stockage level is assigned." These are not replenishment items with stockage levels that are based on mathematical formulas, actual demand, and program data. We have not seen any calculated probabilities for non-demand-based items. The DoD Policy for retaining insurance items, as outlined in DoD Regulation 4140.1-R, "The DoD Materiel Management Regulation," January 1993, allows one replacement unit to be stocked for insurance purposes.

The Deputy Under Secretary referred to DoD studies that provide calculated probabilities showing that economic retention items will be sold in the future (within the 6 year retention period). These studies were not provided to us. In addition, the FY 1997 DoD Supply System Inventory Report classified only about 17 percent of all DoD contingency stock as potential security assistance stock. None of the DLA contingency stock was identified as such. We request that the Deputy Under Secretary of Defense (Logistics) provide, with his comments to the

final report, studies showing the probability that the retention stocks (including those categorized as Numeric Stockage Objective) will be sold within the 6-year retention period.

A.2. We recommend that the Under Secretary of Defense (Comptroller) amend accounting policy to require that stocks retained by the DoD Components for economic reasons and contingencies be shown on the financial statements as Excess, Obsolete, and Unserviceable Inventory and valued at their net realizable value.

Management Comments. The Deputy Chief Financial Officer nonconcurred and stated that the existing DoD policy, which requires that retention stocks be reported as Inventory Held in Reserve for Future Sale and valued at latest acquisition cost, is consistent with Accounting Standard No.3.

Audit Response. The Deputy Chief Financial Officer position was based on the same premise stated by the Deputy Under Secretary of Defense (Logistics), which is DoD can support the likely future sales of retention stocks. We believe that DoD cannot support the likely future sales of retention stocks, for the reasons stated in the audit response to Recommendation A.1. Additionally, the DoD accounting policy does not include one of the key requirements of Accounting Standard No. 3, that the criteria used by management to classify items as Inventory Held in Reserve for Future Sale must be disclosed in the financial statements. Factors to consider in developing the criteria include all relevant costs associated with holding the items (including storage and handling costs), the expected replacement cost of the items, the time required to replenish inventory, the potential for deterioration and pilferage, and the likelihood that a supply of the items will be available in the future.

We request that the Deputy Chief Financial Officer reconsider his position and provide additional comments on this recommendation.

Finding B. Presentation of Inactive Inventory

Inactive inventory was not correctly presented on the DLA WCF financial statements. Specifically, $3.1 billion of stocks retained for economic and contingency reasons and $1.8 billion retained for potential reutilization and disposal were improperly reported as Inventory Held for Sale. This occurred because DLA did not fully comply with the reporting requirements of DoD accounting policy. However, as discussed in finding A, the DoD policy is not consistent with Accounting Standard No. 3 for the reporting of stocks retained for economic and contingency reasons. As a result, users of the DLA financial statements did not have complete and accurate data on two categories of the Inventory, Net, account: Inventory Held for Current Sale and Excess, Obsolete, and Unserviceable Inventory.

Policy on Presentation of Inventory

Federal Government Accounting Policy. Accounting Standard No. 3 requires that a separate category be established for Inventory Held in Reserve for Future Sale. The standard states, "This category should include on-hand stocks that are not readily available in the market or are retained because there is more than a remote chance that they will eventually be needed." Accounting Standard No. 3 also requires that a separate category be established for Excess, Obsolete, and Unserviceable Inventory. This category includes stock that exceeds demands expected to occur during the normal course of operations and does not meet management's criteria for Inventory Held in Reserve for Future Sale.

The Federal Accounting Standards Advisory Board developed these inventory categories to help Congress, agency managers, and other interested parties better understand the utility of property and aid them in controlling and identifying assets that will result in cash inflows from sales.

DoD Policy. DoD Regulation 7000.14-R directs the DoD Components to present inactive inventory that is retained for economic and contingency reasons as Inventory Held in Reserve for Future Sale and to value it at latest acquisition cost. DoD Regulation 7000.14-R also requires that inventory retained for potential reutilization and disposal be presented as Excess, Obsolete, and Unserviceable Inventory and valued at its net realizable value.

Presentation of Inactive Inventory on Financial Statements

The FY 1997 Financial Statements of the DLA WCF did not correctly present inactive inventory.

Stocks Retained for Economic Reasons and Contingencies. The FY 1997 Financial Statements of the DLA WCF incorrectly showed $3.1 billion of inactive stocks ($2.9 billion of stocks retained for economic reasons and $0.16 billion for contingencies) as Inventory Held for Current Sale. To comply with DoD policy, the DLA financial statements should have shown the full value of those stocks as Inventory Held in Reserve for Future Sale. However, as explained in Finding A, the DoD policy is not consistent with Accounting Standard No. 3.

Accounting Standard No. 3 defines excess inventory as inventory that exceeds demands expected to occur during the normal course of operations. Inactive inventory retained for economic reasons and contingencies meets this definition of excess inventory. In Finding A, we recommended that the Principal Deputy Under Secretary of Defense (Logistics) evaluate the method used to compute the net realizable value and determine the appropriate rate for the valuation of stocks retained for economic and contingency reasons. The results of this evaluation will affect the presentation of these stocks on the DLA WCF financial statements.

Until this evaluation is completed, stocks retained for economic and contingency reasons should be reported as Excess, Obsolete, and Unserviceable Inventory and valued at the established net realizable value rate (currently 2.7 percent) The footnotes should also disclose that the Principal Deputy Under Secretary of Defense (Logistics) is evaluating its method of computing the net realizable value to determine the appropriate rate for the valuation of stocks retained for economic and contingency reasons.

Potential Reutilization and Disposal Stock. On its financial statements, DLA did not present the value of inventory held for potential reutilization and disposal in accordance with DoD policy. DoD policy requires that potential reutilization and disposal stock must be presented as Excess, Obsolete, and Unserviceable Inventory and valued at its net realizable value. The DoD policy complies with Accounting Standard No. 3 for the reporting of excess inventory.

DLA incorrectly showed the $1.8 billion latest acquisition value of potential reutilization and disposal stock as Inventory Held for Current Sale, and reduced this amount by showing the $1.75 billion reduction (needed to arrive at the net realizable value) as Excess, Obsolete, and Unserviceable Inventory. As a result, $50 million of net realizable value remained in Inventory Held for Current Sale. To comply with DoD policy, DLA should have shown only the $50 million net realizable value of the potential reutilization and disposal stock as Excess, Obsolete, and Unserviceable Inventory. The footnotes to the category of Excess, Obsolete, and Unserviceable Inventory should have shown that the $1.8 billion categorized by DLA as potential reutilization and disposal stock was reduced to about $50 million using the rate of 2.7 percent of latest acquisition cost established by the Principal Deputy Under Secretary of Defense (Logistics). Because the $1.75 billion reduced the amount of Inventory Held for Current Sale, it did not materially misstate the total Inventory, Net, value of $9.8 billion.

Recommendations and Management Comments

B. We recommend that the Director, Defense Logistics Agency, present all inactive inventory as Excess, Obsolete, and Unserviceable Inventory on the financial statements and disclose how the Defense Logistics Agency identified and valued the stocks retained for economic and contingency reasons and for potential reutilization and disposal.

Management Comments. The Director, Defense Logistics Agency, agreed with the findings that retention and potential excess inventories were improperly classified as Inventory Held for Sale. He also agreed that the $50 million reported as Inventory Held in Reserve for Future Sale should have been reported separately as Excess, Obsolete, and Unserviceable Inventory. The Director agreed to comply with the reporting and disclosure requirements established in Statement of Federal Financial Accounting Standards No. 3, as implemented by DoD accounting policy. He also agreed to comply with any future changes in the DoD policy pertaining to valuation and presentation of retention stocks. The complete text of the DLA response is in Part III.

Part II - Additional Information

Appendix A. Audit Process

Scope

Work Performed. During this part of our audit of the FY 1997 Financial Statements of the DLA WCF, we evaluated the valuation and presentation of inactive inventory on the financial statements. We conducted a separate audit on inactive inventory because the high level of inactive inventory was a primary reason that GAO rated DoD inventory management as a high-risk area. The GAO did not address the valuation of inactive inventory or its presentation on the financial statements.

Limitations to Audit Scope. The scope of our audit was limited in that we did not determine how much of the $4.9 billion of inactive inventory DLA should retain or dispose of. Assessing whether assets are needed is an operational concern. Our assessment of the inactive inventory applies only to how it should be valued and presented on the financial statements. Additionally, we did not evaluate whether the 2.7 percent rate established by the Office of the Principal Deputy Under Secretary of Defense (Logistics) was appropriate for use in valuing stocks retained for economic and contingency reasons. Our scope was also limited because we did not test internal controls.

Because we did not obtain the final version of the financial statements in a timely manner, we were unable to recommend adjustments to the FY 1997 DLA WCF financial statements. Therefore, the recommendations in this report should be considered in preparing the FY 1998 Financial Statements of the DLA WCF.

DoD-Wide Corporate Level Government Performance and Results Act (GPRA) Goals. In response to the GPRA, the Department of Defense has established 6 DoD-wide corporate-level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objectives and goals.

- **Objective:** Fundamentally reengineer DoD and achieve 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

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

- **Financial Management Functional Area. Objective:** Reengineer DoD business practices. **Goal:** Standardize, reduce, clarify, and reissue financial management policies.

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

Methodology

DLA categorized its FY 1997 year-end inventory as $6.7 billion active and $4.9 billion inactive. After accounting adjustments were made for unserviceable materiel and stocks retained for potential reutilization and disposal, the $11.6 billion was devalued to $9.8 billion for reporting on the financial statements. The $9.8 billion reported as Inventory, Net, included $3.1 billion of inactive stock. We reviewed the valuation and presentation of inactive inventory on the FY 1997 Financial Statements of the DLA WCF (including the footnotes) to determine whether they complied with Federal and DoD policies.

Use of Computer-Processed Data. Using the Standard Automated Materiel Management System, DLA produced summary reports showing the stratification of its inventory as active or inactive. We did not evaluate the stratification process, nor did we evaluate the general or application controls over the Standard Automated Materiel Management System.

We reconciled the financial inventory data reported for the period ending September 30, 1997, with reports showing the stratification of inventory for the same period. The difference between the two sets of records was immaterial (less than 1 percent).

Audit Type, Dates, and Standards. This financial-related audit was conducted from October 1997 through March 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

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

Appendix B. Summary of Prior Coverage

The GAO and the IG, DoD, have issued several reports on inactive inventory. These reports are summarized below.

GAO Report No. HR-97-5, "Defense Inventory Management," February 1997. This report was part of a series of GAO reports giving the status of improvements in Federal program areas identified as high-risk because of their vulnerability to waste, fraud, abuse, and mismanagement. GAO reported that DoD had made little overall progress in correcting systemic problems that have traditionally resulted in large amounts of unneeded inventory. In addition, DoD lacked oversight of its inventory, financial accountability remained weak, and inventory requirements were overstated. The report made no recommendations, but concluded that in the short term, DoD needed to reduce excess inventory.

GAO Report No. NSIAD-97-71 (OSD Case No. 1284), "Defense Logistics: Much of the Inventory Exceeds Current Needs," February 1997. This report stated that of the $67 billion that DoD reported in FY 1995 as secondary inventory, $41.2 billion (over 60 percent) was not needed. About $14.6 billion of the unneeded inventory had no projected demand and would probably never be used. Of the $26.6 billion with projected demand, inventory valued at $1.1 billion represented 100 or more years of supply. GAO defined "needed inventory" as stock required for war reserves and current operating requirements. The report made no recommendations, but GAO stressed that DoD had tremendous potential for further inventory reductions. DoD generally agreed with the factual data in the report, but did not agree with the GAO definition of needed inventory. DoD stated that it has consistently defined needed inventory as materiel expected to be used by the end of the 2-year budget cycle.

GAO Report No. NSIAD-93-31 (OSD Case No. 9227), "Defense Inventory: More Accurate Reporting Categories are Needed," August 1993. This report stated that the $53.5 billion of inventory that DoD reported as its AAO in FY 1991 overstated the level of inventory needed to provide uninterrupted supply. The $53.5 billion was overstated by $14.9 billion because it included materiel excess to requirements based on reorder point and replenishment formulas, which represent the inventory required for a 1.9-year period. GAO recommended that DoD report separately the inventory kept on hand to meet the requirements of reorder point and replenishment formulas from additional inventory being reported within the AAO. DoD nonconcurred with the finding and recommendation.

IG, DoD, Report No. 98-179, "Military Department Materiel Returns to the DLA Distribution Depots," July 13, 1998. This report stated that during FY 1997, 114,057 (about 25 percent) of the 458,521 DLA-managed items that Military Department field organizations returned to the 21 distribution depots were not authorized for return by DLA ICPs. As a result, DLA incurred unnecessary processing costs and lost approximately $2.2 million annually because it did not bill the Military Departments for unauthorized returns. Also, the quality and efficiency of distribution operations were adversely affected. The

report recommended that the Director, DLA, identify the Military Department organizations that are making unauthorized returns to the DLA distribution depots and provide them with additional guidance on DoD policy for materiel returns. The report also recommended that the Director, DLA, begin billing the Military Departments for unauthorized returns. DLA concurred with the recommendations in the report.

IG, DoD, Report No. 98-148, "Internal Controls and Compliance with Laws and Regulations for the FY 1997 Financial Statements of the DLA WCF," June 5, 1998. This report stated that the IG, DoD, was unable to render an opinion on the FYs 1997 and 1996 Financial Statements of the DLA WCF because sufficient audit work was not performed and the limited work disclosed additional scope limitations. DLA did not provide a complete set of financial statements in sufficient time to perform the audit, therefore, the financial statements were not considered in attempting to render an opinion. The IG, DoD, also had difficulty gaining access to financial data in the DLA automated systems. Additionally, because of significant deficiencies in the accounting systems and internal controls, the $9.8 billion inventory balance on the FY 1997 financial statements was not verifiable. The report made no recommendations.

IG, DoD, Report No. 94-070, "Materiel Retention and Disposal Procedures for Secondary Items," March 28, 1994. This report stated that wholesale supply activities did not review and validate major segments of materiel categorized as inactive inventory. This condition occurred because item managers established arbitrary review thresholds, automatically disposed of materiel without review, improperly categorized materiel with the potential for reutilization and disposal as stocks that should be retained, and limited their reviews to inactive items. The report recommended that the DoD Components routinely review all line items that include materiel with the potential for reutilization and disposal, promptly reclassify materiel that is being retained, dispose of unneeded materiel, and validate and document the reasons for retaining materiel for contingencies. DLA generally agreed with the recommendations.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Deputy Under Secretary of Defense (Logistics)
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Public Affairs)
Deputy Under Secretary of Defense (Acquisition Reform)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

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

Department of the Air Force

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
  Director, Defense Finance and Accounting Service Columbus Center
Director, Defense Information Systems Agency
Director, Defense Logistics Agency
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, General Accounting Office
National Security and International Affairs Division
Defense and National Aeronautics and Space Administration Management Issues
Military Operations and Capabilities Issues

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Under Secretary of Defense (Comptroller) Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

JUL 10 1998

MEMORANDUM FOR DEPUTY DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE, OFFICE OF THE INSPECTOR GENERAL

SUBJECT: Draft Audit Report on Valuation and Presentation of Inactive Inventory on the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements (Project No. 8FJ-2002.02)

This is in response to the subject report. Specifically, this office provides the following comments regarding Finding A and Recommendation A.2.

Finding A of the subject report asserts that $3.1 billion of stocks retained for economic reasons and contingencies should have been reported as Excess, Obsolete and Unserviceable Inventory. Additionally, the report asserts that although the Defense Logistics Agency complied with Department of Defense (DoD) accounting policy and valued its $3.1 billion of stocks retained for economic and contingency reasons at latest acquisition value, the DoD policy was not in compliance with Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property."

Recommendation A.2. of the report recommends that the Under Secretary of Defense (Comptroller) (USD(C)) amend accounting policy to require that stocks retained by the DoD Components for economic reasons and contingencies be shown on the financial statements as Excess, Obsolete, and Unserviceable Inventory and valued at their net realizable value.

The Office of the USD(C) does not concur with the above assertions or recommendation. DoD accounting policy requires that inventory held for economic or contingency reasons be classified and reported as Inventory Held for Future Sale. That policy is consistent with SFFAS No. 3, which defines Inventory Held for Future Sale as items held "because they are not readily available in the market or because there is more than a remote chance that they will eventually be needed." The SFFAS further provides that Inventory Held for Future Sale shall be valued using the same basis as inventory held for sale in normal operations.

The point of contact for this matter is Mr. Thomas Short. He may be reached by e-mail: shortt@ousdc.osd.mil or at (703) 697-6875 or DSN 227-6875.

Nelson Toye
Deputy Chief Financial Officer

cc: Comptroller, Defense Logistics Agency
Director for Accounting, Defense Finance and Accounting Service/HQ

Deputy Under Secretary of Defense (Logistics) Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION AND TECHNOLOGY

(L/MDM)

07 JUL 1998

MEMORANDUM FOR THE DEPUTY DIRECTOR, FINANCE AND ACCOUNTING
DOD INSPECTOR GENERAL

THROUGH: DEPUTY DIRECTOR, API, FOR CONGRESSIONAL ACTIONS AND REPORTS

SUBJECT: Draft Audit Report on the Valuation and Presentation of Inactive Inventory on the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statement (Project No. 8FJ-2002.02)

This responds to your memorandum of May 7, 1998, on the subject draft audit report. There is one recommendation addressed to this office.

Recommendation A.1. states that "We recommend that the Principal Deputy Under Secretary of Defense (Logistics) evaluate the method used to compute the net realizable value and determine the appropriate rate for valuation of stocks retained for economic and contingency reasons."

We do not concur with this recommendation. The policy for valuation of inventory emanates from the DoD Financial Management Regulation (FMR) Volume 11B which is prepared by the USD (Comptroller). The DoD FMR, in turn, is based on the Statement of Federal Financial Accounting Standards Number 3. The essence of the policy is that inventory held for sale or for future sale shall be valued at latest acquisition cost less an allowance for inventory held for repair. Inventory held as potential reutilization/disposal stock is valued at its net realizable value. We do not agree that economic retention stock or contingency retention stock should be valued at its net realizable value in the same manner as potential reutilization/disposal stock, nor do we agree that a third category for valuing inventory should be created for retention stocks. Economic retention stock is held based on a formula to balance the risk of paying for holding inventory already purchased against the risk for having to repurchase stock once disposed. There are calculated probabilities that stock will be sold in the future even though there may be no demand at the present date. Contingency retention stock is held for specific contingencies like foreign military sales for which there is a probability of future sale. Both the DoD Inspector General and the General Accounting Office are incorrect when they assert that these inventories are not needed and are therefore excess.

Roger W. Kallock
Deputy Under Secretary
of Defense (Logistics)

Final Report Reference

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HEADQUARTERS
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JUL 20 1998

IN REPLY REFER TO DDAI

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

Revised Page 6

SUBJECT: OIG Draft Report, *"Valuation and Presentation of Inactive Inventory on the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements,"* (Project No. 8FJ-2002.02)

This is in response to your May 7, 1998 request. If you have any questions, please contact Ms. Annell Williams, 703-767-6274.

Revised Page 7

Encl

for Sheila P Raines
JEFFREY GOLDSTEIN
Chief (Acting), Internal Review Office

Federal Recycling Program Printed on Recycled Paper

Subject: Valuation and Presentation of Inactive Inventory on the FY 97 Defense Logistics Agency Working Capital Fund Financial Statements (Project No. 8FJ-2002.02)

Finding A: DLA followed DoD accounting policy for valuing inactive inventory. However, the DoD policy was not adequate to ensure that the value of stocks retained for economic and contingency reasons, as reported on the DLA WCF financial statements, reflected the uncertain future utility of those stocks. As a result, the $9.8 billion reported on the financial statements as Inventory, Net, was overstated by as much as $3 billion, and related inventory expense accounts were understated by the same amount.

DLA Comments: Refer to discussion for Recommendation B.

Finding B: Inactive inventory was not correctly presented on the DLA WCF financial statements. Specifically, $3.1 billion of stocks retained for economic and contingency reasons and $1.8 billion retained for potential reutilization and disposal were improperly reported as Inventory Held for Sale. This occurred because DLA did not fully comply with the reporting requirements of DoD accounting policy. However, as discussed in Finding A, the DoD policy is not consistent with Accounting Standards No. 3 for the reporting of stocks retained for economic and contingency reasons. As a result, users of the DLA financial statements did not have complete and accurate data on two categories of the Inventory, Net, account: Inventory Held for Current Sale and Excess, Obsolete, and Unserviceable Inventory.

DLA Comments: Refer to discussion for Recommendation B.

Recommendation B:
The Director, Defense Logistics Agency present all inactive inventory as Excess, Obsolete, and Unserviceable Inventory on the financial statements and disclose how the Defense Logistics Agency identified and valued the stocks retained for economic and contingency reasons and for potential reutilization and disposal.

DLA Comments: Partially concur:

DLA concurs with the findings that Stocks Retained for Economic and Contingencies Reasons, and Potential Reutilization and Disposal Stocks were improperly classified and reported as Inventory Held for Current Sale. DLA also concurs that the $50 million reported under Inventory Held for the future Sale should have been reported separately as Excess, Obsolete, and Unserviceable Inventory and the footnotes should have denoted how the value was derived. For future financial statements, DLA will comply with DoD 7000.14-R and SFFAS No. 3 in the classification and reporting of inactive inventory retained for economic and contingency reasons as Inventory Held in Reserve for Future Sale, and Potential Reutilization and Disposal Stocks as Excess, Obsolete, and Unserviceable Inventory. DLA will also properly disclose on the financial

statements how stocks retained for economic and contingency reasons and for potential reutilization disposal were identified and valued.

DLA does not concur that inventory held for economic and contingency reasons should be reported as Excess, Obsolete, and Unserviceable Inventory and valued at net realizable value. DLA complied with the DoD policy that required inventory held for economic and contingency reasons to be valued at the latest acquisition cost, which we believe, is consistent SFFAS No. 3. SFFAS No. 3 states that inventory held in reserve for future sale "... may be maintained because they are not readily available in the market or because there is more than a remote chance that they will eventually be needed (although not necessarily in the normal course of operations). These stocks shall be classified as inventory held in reserve for future sale. Inventory held in reserve for future sale shall be valued using the same basis as inventory held for sale in normal operations." DLA will comply with any changes to DoD policy on inventory valuation resulting from this audit.

Disposition: Action is considered complete.

Action Officer: Kerri Sawyer, FOXS, 767-7199
Review/Approval: B. A. BLACKMAN, Chief, Financial Policy and Managerial Accounting Group
Coordination: Annell Williams, DDAI

DLA Approval:

JUL 20 1998

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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