Audit Report

INVENTORY VALUATION AT THE
DEFENSE SUPPLY CENTER RICHMOND

Report No. D-2001-079 March 14, 2001

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Acronyms

DLA	Defense Logistics Agency
DSCR	Defense Supply Center Richmond
NSN	National Stock Number
SAMMS	Standard Automated Material Management

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

March 14, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Inventory Valuation at the Defense Supply Center Richmond (Report No. D-2001-079)

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

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The comments received from the Defense Logistics Agency were generally responsive to the Recommendations. However, comments were only partially responsive to Recommendations 1.a. and 1.d. and comments to Recommendations 1.c. and 4 were not responsive. We request that the Defense Logistics Agency provide additional comments to Recommendations 1.a., 1.c., 1.d., and 4 by May 14, 2001.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. James L. Kornides at (614) 751-1400, extension 11 (jkornides@dodig.osd.mil) or Ms. Amy J. Frontz at (614) 751-1400, extension 13 (afrontz@dodig.osd.mil). See Appendix C for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. D-2001-079 **March 14, 2001**
(Project No. D2000FJ-0067.003)

Inventory Valuation at the Defense Supply Center Richmond

Executive Summary

Introduction. The Defense Supply Center Richmond, Virginia, is the lead DLA inventory control point for aviation supplies and manages just over one million different items owned by DLA. At the end of FY 2000, the Defense Supply Center Richmond reported total inventories of about $3.4 billion, which represented about 41 percent of the $8.3 billion of total DLA inventories maintained in the DLA Standard Automated Material Management System.

Objective. The objective of the audit was to evaluate management assertions for valuation, completeness, and existence of DoD inventory accounts and to determine whether the financial statements presented the accounts fairly. This audit focused on the valuation assertion. The objective was to determine whether the values assigned to inventories managed by the Defense Supply Center Richmond were accurately computed in accordance with generally accepted accounting principles and supported by contract data. We also evaluated applicable management controls. See Appendix A for a discussion of the scope and methodology, the management control program, and prior audit coverage.

Results. The Defense Supply Center Richmond assertion that inventory valuation was accurate and supported by contract data was not reliable. Of the 1,037 items selected for review, the values assigned to 689 items (66.4 percent) were not accurately computed based on the latest representative obligations or were unsupported. Specifically, 110 items valued at $11.5 million were inaccurately computed based on the latest representative purchase price and 94 items valued at $8.3 million were not supported because the obligation history records were not available. The original contract was not available to support the obligation history for 485 items valued at $49.1 million.

Additional inaccurate acquisition costs are probable in material amounts in the universe of items managed by the Defense Supply Center Richmond. There were 239,929 items with on-hand inventories valued at $1.2 billion that the Defense Supply Center Richmond managed at the end of FY 2000 with acquisition costs that were coded as being developed using the same methods identified by this audit. Until the deficiencies leading to the inaccurate and unsupportable acquisition costs are corrected and fully disclosed, inventory valuation data from the Defense Supply Center Richmond for $3.4 billion of inventory cannot be relied upon to support the inventory amounts reported on the DLA financial

statements. See the Finding section for a discussion of the audit results and a summary of potential monetary benefits. See Appendix A for a discussion of the management control program.

During the audit, the Defense Supply Center Richmond corrected the acquisition costs of eight items that were inaccurate. Those actions corrected a $7.3 million financial inventory value misstatement. Further, the actions reduced the standard (sales) prices for the affected items and resulted in $9.5 million of funds put to better use for DLA customers for on-hand inventories expected to be sold over the 6-Year Future Years Defense Program. While our review showed that 66.4 percent of the items reviewed at the Defense Supply Center Richmond were not accurately computed or were not supported, similar rates of discrepancy were found in items reviewed at the Defense Supply Centers in Columbus and Philadelphia. The results of the three Centers will be reported in a summary report.

Summary of Recommendations. We recommend that the Commander, Defense Supply Center Richmond, develop and implement procedures to accurately compute acquisition costs based on the latest representative purchase price, identify and correct all acquisition costs in the national inventory record file that were inaccurately computed, and establish a quality assurance program for inventory prices. We also recommend the Commander identify and disclose the amount of on-hand inventories that were valued based on acquisition costs that cannot be supported by contract data, estimate acquisition costs for items without a procurement history based on current manufacturer's price listings or market price quotations, and develop and implement procedures to retain contract data to support the acquisition costs used to value on-hand inventories on the financial statements in accordance with DLA contract retention requirements.

Management Comments. The Director, DLA Logistics Operations, concurred or partially concurred with all recommendations. He agreed to ensure the inventory valuation methodology is fully documented, review updates to the national inventory record file, and eliminate acquisition costs based on cancelled contracts. He also agreed to develop a sampling plan to test accuracy of prices and planned to evaluate the cost and benefits of disclosure of the values of on-hand inventories where contract data do not support acquisition costs. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

Audit Response. The Director, DLA Logistics Operations, comments were partially responsive. The Director did not fully address problems we identified concerning documenting estimated acquisition costs, identifying and correcting erroneously estimated acquisition costs, and identifying those costs that were inaccurately computed during a FY 1992 conversion to a new valuation method. Also, the Director inadvertently failed to respond to the recommendation to review inactive items to ensure acquisition costs are based on the latest representative purchase price. Additionally, the Director's comments on retention procedures did not address developing the procedures needed to retain data to support obligation history records in the Standard Automated Material Management System. We request that DLA provide additional comments on the final report by May 14, 2001.

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Background

We performed this audit in support of the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. Inventory and inventory-related transactions represent major portions of the total assets, obligations, revenue, and expenses reported on the DLA financial statements. Underlying the financial statements are management assertions on the valuation, ownership, existence, completeness, and presentation of inventories. Assertions regarding inventory valuation deal with whether inventories have been included in the financial statements at the appropriate dollar amounts and whether the basis of valuation is appropriate, properly applied, and consistent with previous periods.

This report is the fourth in a series of reports on the amounts of inventories reported on the DoD financial statements. The first report discussed issues regarding the condition and accountability of DoD chemical protective suits. The second report focused on the statistical sampling plan that DLA developed to measure the dollar value accuracy of its inventories reported on the FY 1999 financial statements of the DLA Working Capital Fund. The second report also made reference to the fact that the DLA sampling plan did not include procedures to validate the inventory pricing data in the logistics feeder systems. The third report focused on validating inventory pricing data in the logistics feeder systems for the Defense Supply Center Columbus. This report focuses on validating inventory pricing data in the Standard Automated Material Management System (SAMMS) for DSCR.

DLA provides centralized management of consumable spare parts, food, clothing and textiles, and medical supplies through its inventory control points, which are located at its Defense supply centers in Columbus, Ohio; Philadelphia, Pennsylvania; and Richmond, Virginia. The inventory control points are responsible for maintaining accurate and reliable inventory values.

DSCR is the lead DLA inventory control point for aviation components and manages just over one million items. At the end of FY 2000, DSCR reported total inventories of about $3.4 billion.

Generally Accepted Accounting Principles on Inventory Valuation. The American Institute of Certified Public Accountants designated the Federal Accounting Standards Advisory Board as the accounting standards-setting body for Federal government entities. The Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standard Number 3, "Accounting for Inventory and Related Property," October 27, 1993, provides the inventory valuation policy for Federal government agencies. The policy requires that inventories be valued on the financial statements at historic cost or latest acquisition cost adjusted to approximate historic cost. The costs of an item shall include all appropriate purchase, transportation, and production costs incurred to bring the items to their current location and condition. Any abnormal costs such as excessive handling or rework costs shall be charged to operations of the period. Additionally, the latest acquisition cost method requires that the last representative purchase price be applied to all like items, including those items

acquired through donation or non-monetary exchange. The latest acquisition cost must be adjusted to approximate historic cost. The approximation is accomplished by establishing allowance accounts to capture unrealized gains and losses from price changes occurring throughout the year and using the allowance accounts to revalue ending inventories and cost of goods sold at least annually.

DoD Inventory Valuation Policy. The DoD policy for inventory valuation is established in DoD Regulation 7000.14-R, the "DoD Financial Management Regulation," volume 11B, "Reimbursable Operations, Policy and Procedures for the Defense Business Operations Fund," December 1994. DoD policy requires inventories to be reported on the financial statements at their latest acquisition cost in accordance with generally accepted accounting principles. DoD policy also states that for items without a procurement history, an acquisition cost can be estimated based upon current manufacturer's price listings or market price quotations.

Logistical Reassignment of Inventories. The logistics reassignment process involved the transfer of material management responsibility from a losing DoD inventory manager to a gaining DoD inventory manager. In 1990, the Deputy Secretary of Defense approved the transfer of the management of about 1 million consumable items from the Military Departments to DLA. Additionally, as part of the 1995 Defense base realignment and closure decision, DLA realigned more than 600,000 items among its inventory control points. The logistics reassignments occurred between FY 1991 and FY 2000. DLA Manual 4140.2, volume II, part 1, "Defense Logistics Agency Supply Operations Manual," July 1, 1999, provides the policy for pricing items acquired during the logistics reassignment process. Specifically, the policy requires the gaining inventory control point to use contract history data that the losing inventory control point provided during the logistics reassignment process to price all transferred inventory until additional procurement action takes place at the gaining inventory control point.

Objectives

The objective of the audit was to evaluate management assertions for valuation, completeness, and existence of DoD inventory accounts and to determine whether the financial statements presented the accounts fairly. Our prior audit reports focused on the existence and completeness assertions. This part of the audit focused on the valuation assertion. The objective was to determine whether the values assigned to inventories that DSCR managed were accurately computed in accordance with generally accepted accounting principles and were supported by contract data. We also evaluated applicable management controls. See Appendix A for a discussion of the scope and methodology, the management control program, and prior audit coverage.

Valuation of Inventories

DSCR's assertion that inventory valuation was accurate and supported by contract data was not reliable. Of the 1,037 items selected for review with on-hand inventories valued at $88.3 million, the values assigned to 689 items (66.4 percent) with on-hand inventories valued at $68.9 million were not accurately computed based on the latest representative obligations or fully supported by the originating contract files. Specifically,

- The acquisition costs for 110 items, valued at $11.5 million, were inaccurately computed based on the latest representative purchase price.
- The acquisition costs for 94 items, valued at $8.3 million, were not supported because the obligation history records were not available.
- The acquisition costs for 485 items, valued at $49.1 million, were supported by obligation history record, but the original contract was not available to support the obligation history.

Additional inaccurate and unsupported acquisition costs are probable in material amounts in the universe of DSCR-managed items. Our analysis of the $3.4 billion of FY 2000 DSCR inventories showed that 239,929 of the items, valued at $1.2 billion, had acquisition costs that were coded as being developed in the same manner as those found to be inaccurate and unsupported by our limited review. These conditions occurred because procedures were not in place to compute acquisition costs based on the latest purchase cost information, identify and disclose best values to use in the absence of data, and retain supporting contract data. Additionally, DSCR had not established a quality assurance program for inventory prices. Until the deficiencies leading to the inaccurate and unsupported acquisition costs are corrected and fully disclosed, DSCR inventory valuation data cannot be relied upon to support the inventory amounts reported on the DLA financial statements.

Inventory Items Reviewed

As part of our review of the statistical sampling plan that DLA developed to measure the dollar value accuracy of its inventory amounts reported on the financial statements of the DLA Working Capital Fund, we analyzed the acquisition costs for 1,037 National Stock Numbers (NSN) that DSCR managed. The 1,037 items consisted of 951 items that were included in a total of 3,153 items that DLA randomly selected from the on-hand inventory records maintained in the Distribution Standard System at 11 DLA distribution depots. The 1,037 also included a judgmental sample of 166 items that were selected to provide additional coverage of unusually low and high-value acquisition costs on the DSCR national inventory record file. There were 33 items that were in both

samples but only counted once, and there were 47 items that had no on-hand inventory that were excluded from our review. See Appendix A for details on the sample selection.

We determined whether the acquisition costs used to value the 1,037 items in DSCR financial reports were accurately computed and supported by obligation history records in the SAMMS Pricing System. We then determined whether the obligation history records could be verified to the originating contract files. We performed these tests to verify whether the acquisition costs were based on the latest acquisition cost inventory valuation method as required by generally accepted accounting principles.

Inventory Valuation Processes

DLA Inventory Valuation Policy. The DLA policy for pricing inventory is established in DLA Manual 7000.2, volume II, part 1, "Standard Automated Material Management System Financial Subsystem Operating Procedures," July 1, 1999. DLA policy requires the price for each NSN to be based on the latest procurement cost. According to DLA policy, the Pricing Activity at each inventory control point is the only organization authorized to initiate a revision to an established price. The policy states that each item may be scheduled for review as required to assure that the price is based upon the latest procurement cost and provides instructions on performing the scheduled reviews.

DSCR Inventory Pricing. DSCR uses SAMMS to manage its inventories. SAMMS consists of five operational subsystems: technical, requirements, distribution, procurement, and financial. Inventory prices are calculated within the SAMMS financial subsystem by the Standard Pricing Application (the SAMMS Pricing System). The SAMMS Pricing System computes an acquisition cost for each item based on obligation history records stored in the standard pricing master file and provides the acquisition cost to inventory files in the other four subsystems. The acquisition cost is used to value on-hand inventories on the financial statements and is updated monthly after any procurement action. Additionally, the SAMMS Pricing System calculates a standard price for each item that consists of the item's acquisition cost plus a cost recovery factor or surcharge. The standard price is the sales price charged to customers and is updated annually at the beginning of each fiscal year.

The DSCR Pricing Activity operated under the Office of the DSCR Comptroller and is responsible for maintaining accurate and reliable prices for the one million items managed by DSCR. See Appendix B for a detailed description of the acquisition cost calculation process.

DSCR Financial Inventory Reporting. Within the SAMMS distribution subsystem, the national inventory record file contains the total on-hand asset balance for each NSN that DSCR managed. In addition, the national inventory record file contains each item's acquisition cost that should be derived from the SAMMS Pricing System. At the end of each reporting period, the total DSCR-owned assets are multiplied by the acquisition cost to calculate the extended inventory value for each item. The extended inventory value for all

DSCR-managed items is used to arrive at the total national inventory record file inventory value. The national inventory record file is the source file for the inventory amounts reported on the DSCR Defense Stock Fund Trial Balance. The Defense Finance and Accounting Service relies on the DSCR Defense Stock Fund Trial Balance to prepare the DLA financial statements. DSCR is responsible for ensuring that inventory amounts provided in the national inventory record file and the DSCR Defense Stock Fund Trial Balance are complete, accurate, and reliable.

Acquisition Cost Accuracy

If the latest representative contract buy listed on the Standard Pricing Purchase Record supported the acquisition cost assigned to the item, we considered the item to be adequately supported. We determined that inventory items managed by DSCR were not always accurately valued using available obligation history information. DSCR did not accurately value 110 items, with on-hand inventories valued at $11.5 million, based on the latest representative purchase price on record. The inaccurate acquisition costs resulted in a $7.3 million misstatement of the on-hand inventory values. Our analysis of the acquisition costs reflected the following errors as depicted in Table 1.

Table 1. Items With Inaccurate Acquisition Costs

Reason for Inaccurate Acquisition Cost	Number of Items	Financial Inventory $	Misstatement of Inventory $
Incorrect Estimations	68	$10,098,976	$7,846,892
FY 1992 Conversion to Latest Acquisition Cost	25	336,876	76,470
SAMMS Pricing System Errors	7	936,302	(651,506)
No Acquisition Cost Code Assigned	10	82,017	16,979
Total	**110**	**$11,454,171**	**$7,288,835**

Estimated Acquisition Costs. For 68 of the 110 items that were incorrectly priced, the acquisition costs had been inaccurately estimated. These acquisition costs were identified by an Acquisition Cost Code of "E" indicating they were estimated and not calculated by the SAMMS Pricing System based on obligation history records. (See Appendix B for definitions of the Acquisition Cost Codes.) Documentation was not available to support the methodology used to estimate the acquisition costs and how the acquisition costs differed from the latest representative purchase price on record.

Obligation History Records in the SAMMS Pricing System. There were 14 of the 68 items with estimated acquisition costs that differed from the most recent procurement prices recorded on obligation history records in the purchase trailer section of the SAMMS Pricing System.

For example, one item we reviewed was an actuator fitting (NSN 1560-00-689-8348) managed at DSCR. At the time of our review, there were six fittings on-

hand valued at an acquisition cost of $57,716.55 each. However, the most recent obligation history record in the purchase trailer section of the SAMMS Pricing System was for the stock replenishment of six items at a purchase cost of $2,338.77 each. There were no data supporting the estimated acquisition cost of $57,716.55 and no explanation why the last purchase cost per unit of $2,338.77 was not used. As a result, the acquisition cost of the item was overstated by $55,377.78 and the inventory value for the six on-hand fittings was overstated by $332,266.68

Obligation History Records in Other SAMMS Files. There were 14 of 68 items with estimated acquisition costs that differed from the most recent procurement prices recorded on the obligation history records in other SAMMS contract history files. These 14 items were not supported in the purchase trailer of the SAMMS Pricing System. The obligation history records provided by the previous DoD inventory manager when the item was transferred to DSCR for management were not used to establish the acquisition cost. These obligation history records resided in the SAMMS logistics reassignment data file, a file that serves as a repository for supply management and contract history data provided by the losing DoD inventory manager during the logistics reassignment process, but were not posted to the SAMMS Pricing System. DLA logistics reassignment policy requires that contract history data provided during the logistics reassignment process be used to price all transferred inventory until procurement action takes place at the gaining DLA item manager. By not using the appropriate contract history data, DSCR misstated the inventory value for the affected items.

For example, one item we reviewed was a control unit assembly (NSN 6320-01-085-8788). At the time of our review, there were two units on-hand. The SAMMS Pricing System had an acquisition cost of $51,545.31 that was estimated on October 1, 1996, and there were no obligation history records in the purchase trailer section. Our review of the SAMMS logistics reassignment data file showed that as part of the management transfer, the Navy provided DSCR with an obligation history record showing the last contract unit price paid for the item was $41,968.00. By not using the Navy-provided obligation history data, DSCR overstated the acquisition cost for the item by $9,577.31 and the total inventory value for the two units was overstated by over $19,000.

Obligation History Records in Other Contract History Files. Forty of the 68 items had estimated costs that differed from the most recent procurement prices recorded on obligation history records residing in the procurement history file maintained by the Information Handling Service's Haystack Windows Online Service. For these items, there were no obligation history records in any of the SAMMS contract history files. The Information Service's Haystack Windows Online Service is an online parts research and logistics management system that provides comprehensive information on more than 11 million parts contained in the Federal Supply Catalog and related databases. The Haystack procurement history file contains procurement data obtained on a quarterly basis from the Military Departments and DLA through the Freedom of Information Act. The obligation history record from the procurement history file contains the contract number, source, date of contract award, unit price, purchased quantity and total obligation amount. Contract information from the Haystack procurement history database appeared to be reliable. For 346 of the 348 items in our review we were

able to obtain the contract files, procurement history reports were available from the Haystack service. The pricing information from the contract files for 344 of the 346 items matched the pricing information from the Haystack procurement history file.

Our review of the Haystack procurement history file showed that some items were significantly overvalued. For example, one item we reviewed was a resilient mount (NSN 5342-00-999-1639). At the time of our review, there were 36 issuable mounts on-hand. The SAMMS Pricing System showed an acquisition cost of $203,949.79 that was estimated on January 1, 1999, and no obligation history records resided in the purchase trailer. Additionally, no obligation history data was available in the SAMMS logistic reassignment data file. Our review of a procurement history report from the Information Handling Service's Haystack Windows Online Service showed that the last contract awarded, and not canceled, was for the purchase of 640 mounts at a cost of $810.00 each. The $203,949.79 acquisition cost estimated by DSCR was $203,139.79 more than the last contract cost. The total overstatement of the inventory value for the 36 on-hand mounts was $7,313,032.44

Similar problems may be resident in a material portion of the universe of DSCR-managed items. In addition to the items that were included in our review, 31 percent of the $3.4 billion of inventory reported by DSCR on their September 30, 2000, national inventory record file was valued based on estimated acquisition costs. These data were derived from a program developed by the DLA Systems Integration Office that stratified the number of items and on-hand inventory value in the September 30, 2000 DSCR national inventory record file by Acquisition Cost Code. There were 175,727 items with on-hand assets valued at $1.1 billion that had an Acquisition Cost Code of "E", indicating that they had been estimated.

Conversion to Latest Acquisition Cost. For 25 of the 110 items with an inaccurate acquisition cost, the acquisition cost was calculated when DLA converted to the Latest Acquisition Cost inventory valuation method in FY 1992. These acquisition costs were identified by an Acquisition Cost Code of "C" in the SAMMS Pricing System. The conversion process did not ensure that the newly calculated acquisition cost was supported by the latest stock replenishment obligation.

Before 1992, the inventory maintained in SAMMS was valued at its standard price. The standard price of an item consisted of its acquisition cost plus a cost recovery percentage, or surcharge, and a 3.8 percent inflation factor applied by the managing inventory control point. On July 1, 1992, the DLA Systems Automation Center (renamed the DLA Systems Integration Office in June 1999) completed a major change to SAMMS to value inventory at its latest acquisition cost rather than at its standard price. To compute the latest acquisition cost for each NSN, a one-time procedure was executed that scanned the standard pricing master file and calculated an acquisition cost by removing the surcharge and the 3.8 percent inflation factor from the current standard price.

The conversion process resulted in a misstatement of the inventory value for these 25 items in our review with acquisition cost code "C". To illustrate, one item we

reviewed was an external handle (NSN 1560-01-244-7854). At the time of our review, there were 13 units on-hand valued at an acquisition cost of $28.66 each. The SAMMS Pricing System had an acquisition cost code of "C" indicating that the acquisition cost was calculated when DLA converted to the Latest Acquisition Cost inventory valuation method in FY 1992. However, the Procurement History Report from the Information Handling Service's Haystack Windows Online Service reported a contract for a quantity of 25 each and a unit cost of $129.00 each. We concluded that the acquisition cost of the item was understated by $100.34 and the total inventory value for the 13 on-hand units was understated by $1,304.42

Similar problems may be resident in a material portion of the universe of DSCR-managed items. In addition to the items that were included in our review, 4 percent of the $3.4 billion of inventory reported by DSCR on its September 30, 2000, national inventory record file was valued based on acquisition costs calculated during the conversion to the Latest Acquisition Cost inventory valuation method in 1992. Based on the September 30, 2000, DSCR national inventory record file, there were 64,202 items with on-hand assets valued at about $147.5 million that had an Acquisition Cost Code of "C", indicating the acquisition cost was assigned in the FY 1992 conversion to latest acquisition cost.

SAMMS Pricing System Computations. For 7 of the 110 items incorrectly valued, the acquisition costs were computed by the SAMMS Pricing System based on obligation history records. These items were identified by an Acquisition Cost Code of "A." Flaws in the computation process resulted in a misstatement in the inventory value for the affected items.

Non-representative Buys. Five of the seven items had acquisition costs inaccurately computed by the SAMMS Pricing System because the computation was based on nonrepresentative direct delivery purchase contracts. For example, one item we reviewed was a shielded cable terminating kit (NSN 5970-01-363-5119). The SAMMS Pricing System had an acquisition cost code of "A" indicating the acquisition cost was computed by the SAMMS Pricing System from the purchase trailer section of the standard pricing purchase record. However, the system used a nonrepresentative direct vendor delivery type purchase to establish the acquisition cost of $115.10 per kit. The latest representative buy on the purchase trailer section indicated that acquisition cost should be $157.50 per kit. We concluded that the acquisition cost of the item was understated by $42.40 and the total inventory value of the 15 issuable kits on-hand was understated by $636.00

Canceled Contracts. Another of the seven items had an acquisition cost inaccurately computed by the SAMMS Pricing System based on contracts that had been canceled in their entirety. Our review revealed a flaw in the pricing system that did not allow the acquisition cost to be recalculated using the next most recent stock replenishment obligation when the most recent obligation was cancelled. The acquisition cost calculation in the SAMMS Pricing System was based on contract award rather than the actual receipt of material. When a contract was awarded, an obligation transaction passed from the SAMMS procurement subsystem to the SAMMS Pricing System. The pricing system computed a new acquisition cost using the newly received obligation transaction

and all other eligible obligation records in the purchase trailer of the standard pricing master file. When a contract was canceled, the quantity and dollar value fields of the associated obligation record in the standard pricing master file purchase trailer were updated to reflect zeros. However, the acquisition cost was not recalculated.

The DLA Systems Integration Office personnel stated that SAMMS programming did not allow for the acquisition cost to be re-calculated when a contract was canceled. The computer specialist responsible for maintaining the SAMMS Pricing System agreed to correct the programming as part of an April 2000 systems change. However, the change would not be retroactive. Therefore, any existing acquisition costs that were based on canceled contracts would have to be identified and corrected by the Pricing Activity at each DLA inventory control point.

Other Inaccurate System-Calculated Acquisition Costs. One of the seven items had an inaccurate acquisition cost generated by the SAMMS Pricing System because the system used the last two representative buys on the obligation history purchase trailer. Based on the dates of the buys, only one occurred in a 6-month window and should have been the only one used.

No Acquisition Cost Code Assigned. For 10 of the 110 items that were incorrectly valued, no acquisition cost code was assigned to the item even though the national inventory record file contained on-hand assets.

With Representative Buys. There were two of the 10 items with no acquisition cost code assigned that had representative buys on the SAMMS procurement history purchase trailer, but these buys were not used in the computation of the acquisition costs for the items.

For example, one item, an antenna subassembly (NSN 5985-01-111-8755), was assigned no acquisition cost code in the SAMMS Pricing System. The acquisition cost assigned was equal to the standard price of $12,272.74 each. The SAMMS Pricing System had a representative buy in the purchase trailer section of the standard pricing master file for $8,991.00 each that would better support the acquisition cost. This resulted in an overstatement of the inventory value by $6,563.48 because there were two subassemblies on-hand.

Without Representative Buys. The remaining eight of 10 items had no support on the SAMMS procurement history purchase trailer. The acquisition costs of these items were equal to the standard price of these items. We used the Procurement History Report from the Information Handling Service's Haystack Windows Online Service to determine the acquisition cost.

Quality Assurance Program for Inventory Prices. DSCR did not previously detect the inaccurate acquisition costs we identified because it had not established a quality assurance program to ensure the accuracy of inventory prices. With three pricing analysts responsible for maintaining accurate prices for more than one million items, efforts were focused on ensuring the accuracy of prices recommended by the SAMMS Pricing System for fast-moving (active) items before their release. However, many of the items we found with inaccurate

acquisition costs had little sales and procurement activity (were inactive) and were not reviewed. Some of the inaccurate acquisition costs we identified had resided in SAMMS since FY 1992. In order for DSCR to ensure continued accuracy of all of its prices, it must establish a quality assurance program for inventory prices. As part of this program, the DSCR Pricing Activity should perform scheduled reviews on inactive items using the procedures described in DLA Manual 7000.2 as well as test the accuracy of prices for active items. Additionally, DSCR must retain the results of the tests for audit verification purposes.

Availability of Obligation History Records

For 94 items with on-hand inventories valued at $8.3 million, obligation history records were not available in any of the SAMMS contract history files or the Haystack procurement history database to support the acquisition costs. The obligation history records were not available because they were not obtained during the logistics reassignment process or were purged from the contract history files (See table 2). Without the supporting obligation history records, we were unable to determine the accuracy of the assigned acquisition costs.

Table 2. Items Without Supporting Obligation History Records

Type of Item	Number of Items	Financial Inventory $
Logistic Gain	67	$5,567,905
Other	27	2,697,037
Total	**94**	**$8,264,942**

The SAMMS Pricing System contains a purchase trailer section in its standard pricing master file to store current and historical procurement (obligation) records used in the acquisition cost calculation process. For an item acquired by DSCR through the logistics reassignment process, a purchase record resulting from a DSCR procurement is established and updated by obligation transactions received from the SAMMS distribution subsystem if the transaction is a result of contract history data provided by another DoD inventory control point (a logistic gain).

Each obligation transaction in the purchase trailer section of the SAMMS Pricing System contains the following data: obligation document number, quantity, purchase cost per unit, total obligation amount, government furnished material cost, funds classification code, award date, and modification date. When multiple lines for a given NSN are procured on one contract, all lines are consolidated. The purchase trailer has the capability to store a maximum of 25 purchase records, including the latest three direct delivery purchase records, for each stocked item. The number of obligation trailers stored on each standard pricing master file record varies according to the age of the trailer and the type of item. If the item is a logistic gain that has not had any activity, the system should keep

trailers that are up to five years old. For other items, the system should keep trailers that are up to three years old based on the contract modification date provided in the obligation transaction.

Logistics Gain Items. Of the 94 items, 67 were acquired by DSCR from other inventory control points during the logistic reassignment process. These items were considered logistic gains to DSCR. We researched SAMMS logistics reassignment files for these items and found the obligation history data were not obtained during the logistics reassignment process. For logistics gain items where the obligation records were not obtained, the SAMMS Pricing System is programmed to set the acquisition cost equal to the standard price provided by the DoD inventory control point that previously managed the item. The standard price should represent the cost incurred by the previous DoD inventory manager to acquire the item plus the applicable cost recovery factor or surcharge. Using the standard price to value on-hand inventory resulted in an overstatement of the financial inventory value.

Other Items. Of the 94 items, 27 were not supported by obligation history records and were not identified as logistics gains. For these items, all representative obligation history data was purged from the purchase trailer of the SAMMS Pricing System. We researched additional automated sources of contract data but the other sources of contract data were unable to provide support for the assigned acquisition costs.

Contract Availability

For 485 items with on-hand inventories valued at $49.1 million, obligation history records existed in the purchase trailer data of the SAMMS Pricing System or other obligation history databases to support the acquisition costs, but the originating contract files were not available to support the limited information provided on the obligation history record. The supporting contract files were not available because they were destroyed because their age exceeded DLA contract file retention requirements, were not obtained during the logistics reassignment process, or were simply lost. Details are provided in table 3.

Table 3. Items Without Supporting Contract Files

Reason For Contract Not Available	Number of Items	Financial Inventory $
Logistics Gain Item	363	$44,945,694
Age Exceeded DLA Retention Requirements	80	2,997,473
Within Retention Limit	42	1,132,348
Total	**485**	**$49,075,515**

DLA Contract File Retention Requirements. The DLA policy for retaining contract files is established in DLA Instruction 5015.1, "DLA Records Management Procedures and Records Schedule," March 1, 2000. DLA policy

defines contracts as individual and subcontract case files accumulated from the administration of individual contracts consisting of purchase orders, contracts, comparable instruments, and other documentation, as applicable, as required by the Federal Acquisition Regulation. According to DLA policy, contracts for more than $25,000 shall be retained for 6 years and 3 months after final payment. Contracts for $25,000 or less shall be retained for 3 years after final payment. These retention criteria are based on the timeframes established in the Defense Federal Acquisition Regulation.

DSCR Contract Retention Procedures. DSCR did not have local procedures specifying the time period for retaining contract files. The DSCR activities we visited to obtain contract files informed us that they relied on DLA policy and the Defense Federal Acquisition Regulation. Personnel from the DSCR records holding activity informed us that contract files over 6 years old were generally destroyed unless specific justification was provided for their retention.

Obligation Records for Logistics Gain Items. Of the 485 items that had an obligation history record in the purchase trailer of the SAMMS Pricing System, 363 items did not have the actual contract file because it was not obtained by DSCR during the logistics reassignment process. These items were identified by a type of price change code of "L" to show that the obligation records electronically provided by the previous manager were used in the acquisition cost calculation. We could not be reasonably assured that these obligation records were reliable without reviewing the actual contract files. For 334 of the 363, the obligation record in SAMMS was beyond the retention period, and the contracts have been destroyed.

Obligation Records Exceeding DLA Contract Retention Periods. Of the 485 items that had an obligation history record in the purchase trailer of the SAMMS Pricing System, 80 items did not have the actual contract file because it exceeded DLA's contract retention requirements. The lack of contract files prevented us from determining whether the acquisition costs were based on representative stock replenishment buys and void of abnormal costs such as excessive handling or rework costs. Additionally the age of the most recent obligation history records supporting the acquisition costs raised concerns about the future likelihood of sales of the on-hand inventory.

Obligation Records Within the Federal Contract Retention Period. There were 42 of the 485 items that had an obligation history record in the purchase trailer of the SAMMS Pricing System but the actual contract files were not available for review even though their contract modification dates fell within DLA's contract retention requirements. These items were part of the Logistics Transfer process also and most came from other DLA inventory control points.

Actions Taken and Potential Monetary Benefits

Impact on Financial Reports. During our audit, the DSCR Pricing Activity corrected eight of the inaccurate acquisition costs brought to its attention. By correcting the inaccurate acquisition costs, DSCR improved the accuracy of its on-hand inventory by $7.3 million. This amount represented the variance

between the acquisition cost in the national inventory record file at the time of our review and the latest acquisition cost as determined by our audit. The variance between the acquisition costs was multiplied by the number of DSCR-owned assets on the national inventory record file to arrive at the financial inventory value misstatement for each item. Because the results of the other items that had inaccurate acquisition costs netted each other out (there was as much under as overpriced), the financial inventory value misstatement for all items was also $7.3 million.

Potential Monetary Benefits Resulting from Reduced Selling Prices. By correcting the eight items, DSCR reduced the standard (sales) prices charged to customers by $9.5 million for on-hand inventory expected to be sold over the 6-Year Future Years Defense Program. This amount represented the standard price variance multiplied by the number of DLA-owned assets on the national inventory record file. The standard price variance was the difference between the old standard price (the inaccurate acquisition cost multiplied by the applicable DSCR surcharge) and the revised standard price (the corrected acquisition cost multiplied by the applicable DSCR surcharge). The standard price variance for all items was combined to arrive at the $9.5 million. The $9.5 million reduction in selling price for the on-hand inventory will result in funds put to better use by DSCR customers.

Potential for Additional Acquisition Cost Inaccuracies

There is great potential for the problems identified during the audit to exist in a material amount in the universe of DSCR inventory. During the audit, we identified 68 items that had acquisition costs that were inaccurately estimated (identified by an acquisition cost code of "E"). Additionally, 25 items had acquisition costs that were inaccurately computed during the initial acquisition cost conversion in FY 1992 (identified by an acquisition cost code of "C"). Acquisition cost "C" or "E" was assigned to 93 items out of the 110 items that we reviewed that had inaccurate acquisition costs.

There were a significant number of items in the FY 2000 DSCR national inventory record file that were computed in the same manner as those found inaccurate by our audit. As depicted in table 4, there were 239,929 NSNs with on-hand assets having acquisition costs identified by acquisition cost codes "C" and "E" which represented 56 percent of the 432,201 DSCR-managed items with on-hand inventory. Additionally, the $1.2 billion on-hand inventory value for those items represented over 36 percent of the total $3.4 billion DSCR inventory value as of September 30, 2000.

Table 4. September 30, 2000, DSCR Inventory by Acquisition Cost Code				
Acquisition Cost Code	NSNs With On-Hand Assets	Percent Total NSNs With On-Hand Assets	Total On-Hand Inventory Value	Percent of Total Value
A	191,370	44.2	$2,191,324,177	64.0
C	64,202	14.9	147,464,638	4.3
E	175,727	40.7	1,073,096,316	31.3
Other	902	0.2	12,573,896	0.4
Total	**432,201**[1]	**100.0**	**$3,424,459,027**	**100.0**

Summary

The 1,037 items we reviewed represented only a small portion of the total DSCR inventory because they were selected as part of an effort to measure the accuracy of all DLA-owned inventories. However, we believe that items having acquisition costs that were developed in the same manner as those found to be inaccurate by our review exist in a material amount in the total DSCR inventory. Additionally, the system changes implemented by the DLA Systems Integration Office were not retroactive, and we do not know how many additional items exist in the universe of DSCR inventory that were valued using the inaccurate methods identified. DSCR needs to review the national inventory record file and identify and correct all additional inaccurate acquisition costs.

We also believe that additional inventory valuation problems may have gone undetected because DSCR had not established a quality assurance program to ensure the accuracy of its inventory prices.

Further, we could not determine the reasonableness of the acquisition costs used to value on-hand inventories for items without supporting obligation history records. A significant number of items were valued using acquisition costs that could not be supported by an obligation history record in the SAMMS Pricing System or other automated contract history files. In the absence of procurement histories, DoD 7000.14-R permits DoD activities to estimate acquisition costs based upon current manufacturer's parts listings or market price quotations. DSCR must identify all items that are not supported by obligation history records and estimate a reasonable price using DoD guidance.

Additionally, we could not be reasonably assured that the acquisition costs used to value on-hand inventories were based on the latest representative stock replenishment buy and were void of any abnormal costs without being able to review the supporting contract files. Contract files will not be available to support

[1] DSCR manages over one million items. However, only 432,201 had on-hand assets at September 30, 2000. As a result of DoD inventory reduction initiatives, DSCR manages many items as non-stocked where inventories are shipped directly to DoD customers from contractor facilities.

the significant number of items that had acquisition costs based on obligation history records that were more than 6 years old or that were provided electronically by the Military Departments during the logistics reassignment process. In the absence of the originating contract files, DSCR must disclose the value of the on-hand inventory that cannot be properly supported, and the disclosures must continually be made until the amount of inventory valued based on unsupported acquisition costs is reduced to an immaterial amount. Also, because on-hand inventory is frequently retained longer than the maximum 6-year time period required for retaining the contract files that support the last purchase price, DSCR must establish that the obligation history records in the SAMMS Pricing System are reliable and contain accurate information based on the originating contract files. Until all of those actions are accomplished, we cannot be reasonably assured that financial inventory values that DSCR reported are free from material misstatement.

While our review showed that 66.4 percent of the items reviewed at the Defense Supply Center Richmond were not accurately computed or were not supported, similar rates of discrepancy were found in items reviewed at the Defense Supply Centers in Columbus and Philadelphia. Systemic problems found at the three Centers will be addressed in a summary report.

Management Comments on the Finding and Audit Response

Management Comments on the Valuation of Inventories. The Director, DLA Logistics Operations, provided comments for the Commander, Defense Supply Center Richmond. DLA partially concurred with the finding, but stated that the DLA procedure is to compute the latest representative acquisition cost using the weighted-average acquisition cost of stocked items using the latest contract and any other buys made in the preceding 44 days. DLA concurred that the audit identified areas where DLA could improve policies and procedures.

Audit Response. We accepted the DLA averaging methodology as accurate during the audit. The acquisition costs we identified as inaccurate differed significantly from the most recent representative purchase price, including the average of the most recent purchase price and all buys made in the preceding 44 days.

Recommendations, Management Comments, and Audit Response

We recommend that the Commander, Defense Supply Center Richmond:

1. **Develop and implement procedures to accurately compute acquisition costs used to value on-hand inventories based on the latest representative purchase price. These procedures should require the Defense Supply Center Richmond Pricing Activity to:**

a. Fully document and maintain the methodology used to estimate acquisition costs and use the latest representative purchase price as a basis.

Management Comments. DLA partially concurred and stated that it uses the weighted-average methodology to compute costs from recent representative contract prices. DLA planned to review DLAM 7000.2 and ensure that the DLA inventory valuation methodology is fully documented by July 2001.

Audit Response. The DLA comments were partially responsive to the recommendation. However, the comments did not specifically mention the acquisition costs that are estimated. DLA's corrective actions should specifically include procedures to document the supporting data for acquisition costs that are estimated.

b. Use consistent acquisition cost data in the national inventory record file and the standard pricing master file.

Management Comments. DLA concurred with this recommendation stating that this is DLA practice. DLA does acknowledge instances when an update to the standard pricing master file has not been recorded in the national inventory record file. DLA will conduct a review to identify the causes and take corrective actions by September 28, 2001.

c. Review inactive items to determine whether their acquisition costs are based on the latest representative purchase price.

Management Comments. The DLA response inadvertently addressed a Recommendation contained in another draft report titled Inventory Valuation at the Defense Supply Center Columbus. That recommendation, also numbered 1.c., dealt with correcting all acquisition costs with a zero value.

Audit Response. The DLA comments were not responsive to this recommendation. We request that DLA provide comments to our recommendation to review inactive items to determine whether their costs are based on the latest purchase price as part of its comments to the final report. We request that DLA provide comments to the final report.

d. Identify and correct all acquisition costs residing in the national inventory record file that were computed using the inaccurate methods identified by this audit. Include inaccurately estimated acquisition costs, acquisition costs based on canceled contracts, and acquisition costs computed during the FY 1992 conversion to the latest acquisition cost inventory valuation method.

Management Comments. DLA partially concurred with this recommendation. DLA stated its pricing methodology, averaging the most recent contracts to compute prices, results in more accurate pricing. DLA will review the current DoD inventory valuation policies to ensure

compliance of DLA policies and procedures, especially concerning the appropriateness of eliminating acquisition costs erroneously based on cancelled contracts. Estimated completion date for this action is September 28, 2001.

Audit Response. The DLA comments were partially responsive. DLA did not address acquisition costs that are estimated and those computed during a FY 1992 conversion to a new valuation method. We request that DLA comment on plans to identify and correct those acquisition costs in response to the final report.

2. **Establish a quality assurance program to ensure the accuracy of the acquisition cost assigned to all items of inventory at DSCR. The program must include procedures to test the accuracy of acquisition costs for all items including inactive items.**

   Management Comments. DLA concurred with this recommendation and stated that they will task the Defense Supply Center Columbus with developing a sampling plan to test the accuracy of inventory prices. The Defense Supply Center Columbus will coordinate with the Defense Supply Center Richmond and the Defense Supply Center Philadelphia to see if a sampling plan is already being utilized. Upon completion, the sampling program will be disseminated to other Centers for use as appropriate. The estimated completion date for these actions is September 28, 2001.

3. **Develop and implement procedures to identify and disclose the value of on-hand inventories where contract data do not support acquisition costs. The procedures should identify the total inventory value for items with acquisition costs not supported by obligation history records and require that the acquisition costs for those items be estimated based on current manufacturer's price listings or market price quotations. Additionally, the disclosure should provide the total inventory value for items with acquisition costs based on obligation history records provided by the previous managing inventory control point for logistic gain items and acquisition costs based on the Defense Supply Center Richmond obligation history records more than six years old.**

   Management Comments. DLA partially concurred with the recommendation, stating that they agree in principle with the recommendation, but because it will require an intensive manual effort, they will assess the costs and benefits of any changes to procedures prior to any implementation. Actions will be completed by July 31, 2001.

4. **Develop and implement procedures to retain contract data to support the acquisition costs used to value on-hand inventories on the financial statements. The procedures should require the retention of the latest representative obligation history record in the purchase trailer of the standard pricing master file and require the retention of supporting contract files in accordance with Defense Logistics Agency retention requirements.**

Management Comments. DLA partially concurred with this recommendation, stating that contracts are retained in accordance with Federal Acquisition Regulation requirements and that retention beyond those time frames for items that have not been procured beyond this period would have a far reaching impact not only to DLA but the Military Services. Additionally, the Military Services would also be required to retain and pass the records to the DLA upon logistics reassignments. DLA stated that the recommendation should be addressed to the Under Secretary of Defense (Comptroller) for review and comment.

Audit Response. Although DLA partially concurred with the recommendation, we do not consider its comments responsive. Our recommendation does not require that contract files be retained beyond Federal Acquisition Regulation guidelines and it does not apply to the Military Departments. We found that the SAMMS Pricing System did not always retain the latest representative obligation history record (or records if DLA's weighted average methodology applied). We believe that DLA needs to address the retention limitations of obligation history records in the SAMMS Pricing System. Additionally, DLA needs to issue procedures to its inventory control points specifying the Federal Acquisition Regulation requirements and ensure that these procedures are incorporated in to any automated contract folder initiatives. We request that DLA provide comments to the final report.

Appendix A. Audit Process

Scope

We performed this audit as part of 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. For this part of the audit, we limited the scope of our review to verifying the accuracy of inventory valuation information at DSCR.

Work Performed. We performed the audit at DLA headquarters, DSCR, and the DLA Systems Integration Office. We analyzed the acquisition costs for 1,037 DSCR-managed NSNs to determine whether the acquisition costs were calculated in accordance with generally accepted accounting principles. Our analysis included verifying the acquisition costs to the originating detailed transaction data (the contract). As part of our audit, we reviewed numerous inventory-related documents including:

- generally accepted accounting principles, DoD financial management regulations, and DLA procedures and policies on valuing and reporting inventories;
- file interrogation reports for each applicable item from the SAMMS standard pricing master file, national inventory record file, and the logistics reassignment data file;
- DLA Systems Integration Office documents describing SAMMS Pricing System;
- procurement history reports from the Information Handling Service's Haystack Windows Online Service for each applicable item;
- DD Form 1155, "Order For Supplies Or Services," and related contracting documents supporting obligation records used in calculating the acquisition cost for each applicable item; and
- SAMMS transaction history file reports (for the maximum 24-month period) for items that were found to be inaccurately priced.

We verified the acquisition cost for each item by obtaining contract data at the managing inventory control point because the acquisition cost in DLA is updated when a contract is awarded and not upon the receipt of goods. In addition, we did not believe that sufficient invoice data would be available at the DLA distribution depots because they are required to retain copies of receipt invoices (DoD Form 250 - Material Inspection and Receiving Reports) for a period of only two years. In addition, we believed that the significant relocation of inventories resulting from Defense base realignment and closure actions would also limit the availability of original invoice data.

Limitations to Audit Scope. Our audit work was limited to determining whether the acquisition costs used to value DSCR inventory were based on generally accepted accounting principles and supported by contract data. We did not assess the reasonableness of the price paid for the items or the reasonableness of the DSCR surcharge rates.

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

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

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

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

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to 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. **(FM-4.1)**

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

Methodology

We reviewed Federal accounting standards, DoD, and DLA policies and procedures for valuing inventories. We also interviewed various DSCR personnel involved in the inventory valuation process including procurement specialists and pricing analysts. In addition, we interviewed computer specialists at the DLA System Integration Office who were responsible for supporting the SAMMS Pricing System.

We performed a review of the acquisition costs used to value 1,037 DSCR-managed NSNs on the SAMMS national inventory record file which serves as the source file for the on-hand inventory value on the DSCR Stock Fund Trial Balance. We interrogated the SAMMS standard pricing master file for each

NSN to determine the methodology used to calculate the acquisition cost. We also reviewed the purchase trailer data section of the SAMMS Pricing System to determine whether obligation history records supported the acquisition cost. In addition, we reviewed procurement history reports from the Information Handling Service's Haystack Windows Online Service for each NSN to determine whether obligation history records supported the acquisition cost. We also reviewed SAMMS logistics reassignment data files for each item. For items with obligation records that supported the acquisition cost, we requested the contract folder from the appropriate DSCR activity. We reviewed the contract folder for each item to determine if the obligation data maintained in the standard pricing master file was complete and accurate and reflected the last representative invoice price as defined by Federal accounting standards. For items that were found to be inaccurately valued, we obtained SAMMS transaction history file reports for the maximum 24-month period available to determine whether any assets had been sold at the inaccurate price. Additionally, we obtained the DSCR surcharge rates for FY 1999 in order to calculate the impact the inaccurate acquisition costs had on the standard price.

Universe and Sample. In June 1999, DLA fielded a sampling plan to test the accuracy of the portion of its inventory stored at 18 DLA distribution depots operating under the Distribution Standard System. As part of that effort, DLA used a two-stage, stratified, random sampling procedure to select a sample of 3,153 records from the Distribution Standard System operating files at 11 DLA distribution depots for the period ending June 30, 1999. NSN by location (all condition codes) served as the unit of analysis or sample record. Inventory values for the 3,153 records were determined using the acquisition cost from the SAMMS operating files at the managing DLA inventory control points.

In our review of the DLA sampling plan, we reported that it did not include procedures to test the accuracy of the unit prices in the SAMMS operating files at the managing DLA inventory control points. We decided to test the accuracy of the 3,153 records in SAMMS. Of the 3,153 records, 951 were identified in the Distribution Standard System as being managed by DSCR.

In addition to the 951 items, a judgmental sample of 166 items were selected for review from the SAMMS national inventory record file, which serves as the source file for the inventory amounts reported on the financial statements. The 166 items were selected as part of our sample to provide greater coverage of the unusually low and high acquisition costs and acquisition costs lacking an Acquisition Cost Code. We found that 33 items were duplicates because they were in both samples. After eliminating the 33 duplicates, we had a total of 1,084 sample items managed by DSCR. Forty-seven of these items had no assets on-hand as of the June 30, 1999, selection date. After eliminating these items, the total number of items reviewed that were managed by DSCR was 1,037. This report does not project the results from the 1,037 items to the DSCR total inventory universe. However, we will comment on the total 3,153 records selected as part of the DLA Sampling Plan in a summary report.

Use of Computer-Processed Data. To achieve the audit objective, we relied on computer-processed data from the DLA SAMMS. We did not test the general and

application controls in SAMMS. Specifically, we analyzed the acquisition costs and obligation history data in the national inventory record file and the standard pricing master file.

Of the 1,037 items that we reviewed, we determined that the computer-processed acquisition cost data were unreliable for 110 items in the national inventory record file. We were not able to determine the reliability of the computer-processed acquisition cost data in the standard pricing master file for 579 items because DSCR could not provide the obligation history records (94 items) or the originating contract files (485 items). The computer-processed acquisition cost and supporting obligation history data in the standard pricing master file were reliable for 348 of the 1,037 items that we reviewed because we were able to verify the accuracy of the information to source documents.

Audit Type, Dates, and Standards. We performed this financial-related audit from October 1999 through November 2000. Our review was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

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

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996 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 those controls.

Scope of the Review of the Management Control Program. We reviewed the FY 1999 Annual Statement of Assurance issued by DLA to determine whether the issues addressed in this report had been reported as material management control weaknesses.

Adequacy of Management Controls. We identified material management control weaknesses, as defined by DoD Instruction 5010.40, related to the valuation of DSCR-managed inventory. Management controls did not ensure that DSCR inventory was properly valued in accordance with Federal accounting standards. 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 the DSCR inventory values. A copy of this report will be provided to the senior official responsible for management controls at DSCR. Because similar problems were identified at other Defense Supply Centers, a copy will also be provided to the senior official responsible for internal controls at DLA.

Adequacy of Management's Self-Evaluation. The FY 1999 DLA Annual Statement of Assurance did not identify any material control weaknesses related to the valuation of DSCR-managed inventory.

Prior Coverage

Inspector General, DoD

Inspector General, DoD, Report No. D-2001-078, "Inventory Valuation at the Defense Supply Center Columbus," March 14, 2001

Inspector General, DoD, Report No. D-2000-138, "Procedures Used to Test the Dollar Accuracy of the Defense Logistics Agency Inventory," June 1, 2000

Inspector General, DoD, Report No. D-2000-086, "Assuring Condition and Inventory Accountability of Chemical Protective Suits," February 25, 2000

Appendix B. Acquisition Cost Calculation

As described by DLA Manual 7000.2, volume II, part I, "Standard Automated Material Management System Financial Subsystem Operating Procedures," July 1, 1999, the acquisition cost calculation is an automated process that the Pricing System performs within the SAMMS financial subsystem. SAMMS maintains one acquisition cost value for each NSN without regard to the number of assets on-hand. The acquisition cost is recomputed as new procurement actions occur. The acquisition cost for an item is equivalent to its average replacement cost as calculated from obligation history records contained on the standard pricing master file. The acquisition cost is the sum of all eligible obligation amounts divided by the sum of their obligation quantities plus Government-furnished material costs and any other applicable costs contained on the standard pricing master file. Acquisition costs for stocked items are calculated using an average of all stock replenishment buys awarded during the past 6 months, plus all other stock replenishment buys that have occurred within 45 days of the latest stock buy. The quantity of the buys used must also be at least equal to one month's demand based on historical data. All mechanically recommended price changes are held in suspense at least seven days to enable the Pricing Activity to review, revise, or delete as applicable.

Each item that is assigned an acquisition cost has a corresponding acquisition cost date and Acquisition Cost Code. The acquisition cost date is the Julian date on which the acquisition cost became effective and should always be the first of the month. The Acquisition Cost Code is a one-position field describing how the acquisition cost was developed. The Acquisition Cost Codes are defined in the following table.

Definitions of Acquisition Cost Codes

ACC	Definition
A	Acquisition cost was computer generated based on obligation transactions in the standard pricing master file. The transactions may result from a DLA award or from obligation transactions provided by the previous inventory manager if the item was a logistics gain.
C	Acquisition cost was computed during a DLA-wide conversion from standard price to latest acquisition cost in July 1992, and no procurement action took place since the initial conversion.
E	Acquisition cost was estimated.
G	Acquisition cost was based on the standard price provided by the previous manager upon transfer of management responsibility to DLA.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
    Deputy Chief Financial Officer
    Deputy Comptroller (Program/Budget)

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

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

Other Defense Organizations

Director, Defense Logistics Agency
    Commander, Defense Supply Center Richmond

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

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

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-3

FEB 16 2001

MEMORANDUM FOR DDAI

SUBJECT: Audit Report on Inventory Valuation at the Defense Supply Center Richmond, Project No. D2000FJ-0067.003 (formerly Project No. OFJ-2102.03)

As requested in your memorandum dated December 18, 2000, attached are J-3's comments on the subject report.

D. H. STONE
Rear Admiral, SC, USN
Director
Logistics Operations

Attachment

Federal Recycling Program Printed on Recycled Paper

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

IN REPLY REFER TO J-33

FEB 8 2001

MEMORANDUM FOR J-31

SUBJECT: Audit Report on Inventory Valuation at the Defense Supply Center Richmond, Project No. D2000FY-0067.003 (formerly Project No. OFJ-2102.03)

Comments to subject audit are attached as requested. Coordination is also provided at Attachment 2. Because the recommendations are regarding pricing, we recommend that any follow-up to the report be forwarded to J-8 for action.

William J Kenny
WILLIAM J. KENNY
Executive Director
Logistics Policy and Acquisition Management

Attachments

Federal Recycling Program Printed on Recycled Paper

Subject: Audit Report on Inventory Valuation at the Defense Supply Center Richmond, Project No. D2000FJ-0067.003 (formerly Project No. OFJ-2102.03)

Finding: The Defense Supply Center Richmond assertion that inventory valuation was accurate and supported by contract data was not reliable. Of the 1,037 items selected for review with on-hand inventories valued at $88.3 million, the values assigned to 689 items with on-hand inventories valued at $69.9 million were not accurately computed based on the latest representative obligations or were unsupported. Until the deficiencies leading to the inaccurate and unsupported acquisition costs are corrected and fully disclosed, DSCR inventory valuation data cannot be relied upon to support the inventory amounts reported on the DLA financial statements. (See page 3 of report).

DLA Comments: Partially Concur. The DLA procedure is to compute the latest representative acquisition cost using the weight average acquisition cost of stocked items using the latest contract and any other buys made in the preceding 44 days. For nonstocked items, the weighted average of the prices of all buys in the last 6 month period from the most recent buy is used. DLA uses this weighted average method which dampens the impact of wide fluctuations in quantities and resulting unit prices that can occur within such short timeframes. This methodology is the best approach for the types of items managed by DLA. We do concur that the audit has identified areas where we can improve the policies and procedures. These are addressed in the following recommendations.

Recommendations for Commander, Defense Supply Center Richmond:

1. Develop and implement procedures to accurately compute acquisition costs used to value on-hand inventories based on the latest representative purchase price. The procedures should require the DSCR Pricing Activity to:

a. Fully document and maintain the methodology used to estimate acquisition costs and use the latest representative purchase price as a basis.

DLA Comments: Partially Concur. To determine the acquisition cost of an item, DLA uses the weighted average of costs from recent representative contract prices. We agree that the procedure should be fully documented, and included in DLAM 7000.2. We will review the manual and ensure that the current policy is appropriately documented. Action to be completed by July 2001.

Disposition:
(X) Action is ongoing. ECD: July 31, 2001
( ) Action is considered complete.

b. Use consistent acquisition cost data in the national inventory record file and the standard pricing master file.

DLA Comments: Concur. This is the DLA practice. The standard pricing master file is the source of the acquisition costs data in the national inventory record file; however, instances can occur when an update to the standard pricing master file has not yet been recorded in the national inventory record file. DLA will conduct a review to identify causes and take any required corrective actions.

Disposition:
(X) Action is ongoing. ECD: September 28, 2001
( ) Action is considered complete.

c. Use the program developed by the DLA Systems Integration Office to identify and correct all acquisition costs with a zero value at the end of each reporting period.

DLA Comments: Partially Concur. While DSIO has developed a program to provide data to DODIG Teams, this has been done on one time basis. There is no recurring report at this time. DLA will review items with stock on hand that show no acquisition cost and update as appropriate. In addition, we will refer this requirement to our Business Systems Modernization office for inclusion in the new automated system.

Disposition:
(X) Action is ongoing. ECD: September 28, 2001
( ) Action is considered complete.

d. Identify and correct all acquisition costs residing in the national inventory record file that were computed using the inaccurate methods identified by this audit. Include inaccurately estimated acquisition costs, acquisition costs based on canceled contracts, and acquisition costs computed during the FY 1992 conversion to the latest acquisition costs inventory valuation method.

DLA Comments: Partially Concur. DLA has found that our pricing methodology of averaging the most recent contracts to compute the prices results in more accurate pricing for the types of items that we manage. DLA will review the current DoD inventory valuation policies to ensure compliance of DLA policies and procedures, especially concerning the appropriateness of eliminating acquisition costs erroneously based on canceled contracts. Based on this review, DLA will take action as appropriate.

Disposition:
(X) Action is ongoing. ECD: September 28, 2001
( ) Action is considered complete.

2. Establish a quality assurance program to ensure the accuracy of the acquisition cost assigned to all items of inventory at DSCR. The program must include procedures to test the accuracy of acquisition costs for all items including inactive items.

DLA Comments: Concur. The Defense Supply Center Columbus will be asked to develop a sampling program to test accuracy of inventory prices. Particular attention will be given to stratification by date of last procurement activity. DSCC will coordinate with DSCR and DSCP to see if a sampling program is already being utilized. Upon completion, a sampling program will be disseminated to the other Centers for use as appropriate.

Disposition:
(X) Action is ongoing. ECD: September 28, 2001
( ) Action is considered completed.

3. Develop and implement procedures to identify and disclose the value of on-hand inventories where contract data do not support acquisition costs. The procedures should identify the total inventory value for items with acquisition costs not supported by obligation history records and require that the acquisition costs for those items be estimated based upon current manufacturer's price listings or market price quotations. Additionally, the disclosure should provide the total inventory value for items with acquisition costs based on obligation history records provided by the previous managing inventory control point for logistics gain items and acquisition costs based on Defense Supply Center Richmond obligation history records more than 6 years old.

DLA Comments: Partially Concur. We agree in principle with the recommendation but because this will require an intensive manual effort, we will assess the costs and benefits of changes prior to implementation.

Disposition:
(X) Action is ongoing. ECD: July 31, 2001
( ) Action is considered complete.

4. Develop and implement procedures to retain contract data to support the acquisition costs used to value on-hand inventories on the financial statements. The procedures should require the retention of the latest representative obligation history record in the purchase trailer of the standard pricing master file and require the retention of supporting contract files in accordance with Defense Logistics Agency retention requirements.

DLA Comments: Partially Concur. DLA retains contract files in accordance with the Federal Acquisition Regulation. Retention beyond these timeframes for items that have not been procured beyond this period would have far reaching impact not only DLA but the Military Services. The Military Services would also be required to retain and pass these records upon logistics reassignments. This recommendation should be readdressed to the Under Secretary (Comptroller) for review and comment.

Disposition:
( ) Action is ongoing. ECD:
(X) Action is considered complete.

Audit Team Members

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

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