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

REPORT
NO. 90-026

December 28, 1989

MEMORANDUM FOR COMPTROLLER OF THE DEPARTMENT OF DEFENSE
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Final Report on the Audit of the Surcharge Rate Process for the Defense Stock Fund (Project No. 9FH-0034)

Introduction

This is our final report on the audit of the Surcharge Rate Process for the Defense Stock Fund (the stock fund). The objective of the survey was to determine if the internal controls employed by Defense Logistics Agency (DLA) to govern the Defense Stock Fund were adequate. We evaluated internal controls over the developing and updating of the surcharge rates to ensure the integrity of the Defense Stock Fund. As an audit follow-up issue, internal controls over the reconciliation of accounts receivable were evaluated to ensure that accounts receivable balances were accurate. Fiscal year 1988 Defense Stock Fund sales of all commodities, excluding petroleum, were $6.3 billion. We concluded that further audit effort was not warranted.

Scope of Survey

The self-initiated audit was made at the Office of the Secretary of Defense (OSD); the Headquarters, Defense Logistics Agency; the Defense General Supply Center, Richmond, Virginia; and the Defense Personnel Support Center, Philadelphia, Pennsylvania (see Enclosure 1). We reviewed regulations, procedures, management reports, financial records, and supporting documentation for FY 1986 through FY 1988 as a followup to Office of the Assistant Inspector General for Auditing Report No. 84-072, "Defense Logistics Agency Defense Stock Fund," April 18, 1984, and "Defense Electronics Supply Center," a report issued by the Assistant Inspector General for Inspections in December 1986. We interviewed management and operational personnel to determine and evaluate the procedures and policies for setting surcharge rates. We evaluated DLA's internal control system for compliance with Office of Management and Budget (OMB) Circular A-123, "Internal Control Systems," and we evaluated DLA's accounting system for compliance with OMB Circular A-127, "Financial Management Systems." We designed our substantive tests to verify that rates were computed according to regulations; that rates were appropriately reviewed and charged; that inventories were maintained at authorized levels; that refunds of stock fund cash were authorized and distributed; that accounts receivable balances were accurate; and that collections were actively pursued.

This performance review was made between April 1 and June 30, 1989. We did not evaluate the adequacy of the cash requirement standards established by the Comptroller, Department of Defense for all stock funds. These standards can affect the surcharge rate process and the amounts to be refunded to customers. The General Accounting Office is currently addressing, in its DoD-wide audit of stock funds, the adequacy of DoD cash requirement standards. The survey was made in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD, and accordingly included such tests of internal controls as were considered necessary.

Background

The National Security Act of 1947 authorized the Military Departments, the National Security Agency, and DLA to maintain stock funds. Stock funds finance inventories that will be used by the consuming organizations.

The DLA Defense Stock Fund sales for FY 1988 were about $6.3 billion for all commodities except petroleum, and the anticipated sales for FY 1989 were expected to be the same. Commodities such as food, clothing, medical, industrial, construction, electronic, and general supplies are procured, stored, and sold to the Department of Defense, Government agencies, and other authorized customers. Petroleum sales amounted to approximately $6 billion for FY 1988, and the same amount was expected for FY 1989.

The stock fund consists of cash on deposit with the Department of the Treasury, accounts receivable, and inventories. The stock fund is a revolving fund that operates with a funding level established by Congress. When an item is issued from the stock fund, the organization that consumes the item is billed at a rate to cover replacement cost of the commodity plus a surcharge fee. The surcharge fee covers transportation costs, expected inventory loss, and a price stabilization fee for the commodities sold. The price stabilization fee is designed to keep the effects of inflation on commodity prices stable for the customers of the stock fund.

Commodity stock fund prices are established prior to the beginning of each fiscal year at a fixed rate for the year. The surcharge rate is established 2 years in advance based on DLA cost data for transportation costs, normal inventory loss expenses, and OSD's inflation and price stabilization rate factors. Congress gives final approval on commodity prices and surcharge rates.

Prior Audit Coverage

The Assistant Inspector General for Auditing issued Report No. 84-072, "Defense Logistics Agency Defense Stock Fund," April 18, 1984. The report found that transportation and inventory loss surcharges assessed by the Supply Centers exceeded actual expenses incurred, and that differences between accounts receivable general ledger balances and detailed supporting records were not being resolved.

The report recommended that the required analysis be made for transportation and inventory loss surcharges, and that appropriate adjustments be made to those rates. It also recommended that differences between the accounts receivable general ledger and supporting records be researched and resolved, and that the records be adjusted accordingly. DLA concurred with the recommendations, implemented them, and closed the case.

The Office of the Assistant Inspector General for Inspections (OAIG-INS) made an inspection of the Defense Electronics Supply Center from December 2 to December 19, 1986.

Discussion

Our review showed that DLA's internal controls for developing and updating the surcharge rates were adequate to ensure the integrity of the Defense Stock Fund. Also, the reconciliation process for accounts receivable was effective to ensure that the balances were accurate. Therefore, no audit recommendations are required.

Surcharge-Rate Process. DLA developed surcharge rates for FY 1986 through FY 1988 that complied with applicable regulations, that were appropriately reviewed by OSD, and that were implemented as approved by Congress. DLA, OSD, and Congress monitored the adequacy of the surcharge rates to ensure commodity price stabilization and its effect on DLA cash requirements and inventory levels.

Department of Defense Directive 7420.13, "Stock Fund Operations," January 27, 1983, established the rate development process and defined OSD and DLA responsibilities. DLA's "Accounting and Finance Manual," DLA Manual 7000.1, Chapter 7 established the process for rate development, collection, and reporting of surcharge-rate collections. Our survey tests were designed to evaluate the DLA's and OSD's compliance with these requirements during the survey period. Both DLA and OSD officials involved in the surcharge-rate process were interviewed, and files were evaluated to determine if the surcharge development process was followed, documented, and controlled to ensure the integrity of the stock fund. The survey results showed that the process was understood and followed, and

that it complied with applicable regulations. Also, the rates established during the audit period were appropriately reviewed and approved by DLA, OSD, and Congress.

Audit tests of DLA's accounting records verified that rates were appropriately developed, charged, and collected. Our independent calculation of the rates for the years reviewed noted no variances from the published rates. Our analysis, using actual data to compute the rates versus the projected data used to establish the rate 2 years in advance, also noted no material variances. Thus, we believe the surcharge-rate process is effective in determining future needs of the fund and should ensure the integrity of the fund. Also, we evaluated DLA's year-end financial reports to the Department of the Treasury. Our analysis of these reports and their supporting documentation verified that stock fund assets were maintained and that cash refunds from the fund were issued as approved by Congress. The audit trail supporting the development of surcharge rates was weak; only the final products were available for our review. Therefore, we reconstructed the process and found no material effects because of this minor control weakness. Management has begun some corrective actions and proposed others, which should correct this audit trail weakness.

Reconciliation of Accounts Receivable. The DLA Defense Stock Fund reconciliation process for accounts receivable complied with applicable regulations and corrected deficiencies noted in the prior DoD Inspector General audit report. Amounts owed by DoD Components were collected by an automatic transfer of funds at the end of each month. Collections from other Government agencies and other authorized users were processed manually. Accounts receivable balances were reconciled monthly and aged quarterly (newest to oldest). Old outstanding accounts receivable balances were monitored and billed by an automated debt collection process to ensure collectibility.

We evaluated the accounts receivable process by analyzing DLA's internal control objectives and techniques for accounts receivable noted in DLA's "Accounting and Finance Manual;" and determined that the internal controls complied with the requirements of OMB Circular A-123, "Internal Control Systems." Tests of the collection process for the period August to October 1988 were performed at the Defense General Supply Center (DGSC), Richmond, Virginia. We evaluated the process used for recording, reconciling, aging, and collecting accounts receivable, and we found it to be effective and in compliance with the DLA Manual. Weaknesses in the internal control process (identified in our prior audit report) that caused inaccurate accounts receivable balances have been corrected. Discussions with management at the Defense Personnel Support Center indicated that the internal controls for accounts receivable were the same as those used at DGSC.

At Headquarters, DLA, the Comptroller certified the accounts receivable balance for FY 1988 with the Defense Stock Fund Statement of Financial Condition. The Standard Automated Materiel Management System that maintains the accounts receivable was subject to an internal control review as outlined in OMB Circular A-123. DLA managers determined that their accounting system was in compliance with the Federal Managers' Financial Integrity Act (FMFIA) of 1982 and reported compliance to the President and Congress. These actions confirmed management's control objectives for accounts receivable: accurate, reliable, and timely reporting and collection of monies owed.

Conclusion

Our review determined that DLA's internal controls for developing and updating surcharge rates were adequate, and that internal controls over the reconciliation of accounts receivable to subsidiary records were adequate to ensure that accounts were accurate and collectible.

A copy of the draft report was provided to the Comptroller of the Department of Defense and the Director, Defense Logistics Agency on October 6, 1989. Comments were not required and none were received. This final report does not contain any findings or recommendations for corrective actions. Accordingly, comments pursuant to the provisions of DoD Directive 7650.3 are not required. Distribution of the final report is shown at Enclosure 3.

The cooperation and courtesies extended to the auditors during this project are appreciated. A list of audit team members is at Enclosure 2. If you have any questions about this audit, please contact Mr. Robert J. Coffey at (202) 694-2397 (AUTOVON 224-2397) or Mr. Christian Hendricks at (202) 694-8492 (AUTOVON 224-8492).

Edward R. Jones
Deputy Assistant Inspector General
for Auditing

Enclosures

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Comptroller of the Department of Defense

Defense Logistics Agency

Headquarters, Defense Logistics Agency, Alexandria, VA
Defense General Supply Center, Richmond, VA
Defense Personnel Support Center, Philadelphia, PA

AUDIT TEAM MEMBERS

Nancy L. Butler	Director, Financial Management Directorate
Robert Coffey	Program Director
Christian Hendricks	Project Manager
Shirley Kent	Team Leader
Anne Meals	Auditor
Jeffrey Bailey	Auditor
Robert Hoss	Auditor

FINAL REPORT DISTRIBUTION

Office of the Secretary of Defense

Comptroller of the Department of Defense
Director, Defense Logistics Agency

Non-DoD

Office of Management and Budget
U.S. General Accounting Office,
NSIAD Technical Information Center

Congressional Committees:

Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Ranking Minority Member, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations