Audit Report

REVALUATION OF INVENTORY FOR THE FY 1999
DEPARTMENT OF THE NAVY WORKING CAPITAL
FUND FINANCIAL STATEMENTS

Report No. D-2000-177 August 18, 2000

Office of the Inspector General
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Acronyms

CDB	Central Data Base
COGS	Cost of Goods Sold
CSIS	Central Secondary Item Stratification
DFAS	Defense Finance and Accounting Service
NAS	Naval Audit Service
NAVSUP	Naval Supply Systems Command
USD(Comptroller)	Under Secretary of Defense (Comptroller)

INSPECTOR GENERAL
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August 18, 2000

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
NAVAL INSPECTOR GENERAL

SUBJECT: Audit Report on Revaluation of Inventory for the FY 1999 Department of the Navy Working Capital Fund Financial Statements (Report No. D-2000-177)

We are providing this report for information and use. We performed this audit in response to 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.

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

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Marvin L. Peek at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil) or Mr. Joel K. Chaney at (216) 522-6091, ext. 235 (DSN 580-6091) (jchaney@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

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Report No. D-2000-177 **August 18, 2000**
(Project No. D2000FC-0045.002)

Revaluation of Inventory for the FY 1999 Department of the Navy Working Capital Fund Financial Statements

Executive Summary

Introduction. This report is the fourth in a series of reports on the FY 1999 Department of the Navy (Navy) Working Capital Fund financial statements. We performed this audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, which requires DoD to provide audited financial statements to the Office of Management and Budget. The FY 1999 Navy Working Capital Fund financial statements reported total assets of $23.4 billion and total liabilities of $5.5 billion. Net program costs for the Navy Working Capital Fund were $710.9 million. Inventory is the most significant asset of the Navy Working Capital Fund and comprised $15.2 billion, or about 67 percent of the reported assets.

Objectives. Our objectives were to determine whether the revaluation of inventory from standard price to an estimation of historical cost was reasonable, and to evaluate the processes and procedures that the Naval Supply Systems Command and the Defense Finance and Accounting Service (DFAS) used to revalue inventory. We also reviewed management controls and compliance with laws and regulations as they related to the audit objective. See Appendix A for a discussion of the audit process.

Results. Calculations in the Cost of Goods Sold model that DFAS used since 1995 did not follow Federal accounting standards or DoD guidance for the presentation and disclosure of inventory in the FY 1999 Navy Working Capital Fund financial statements. As a result, the Inventory, Net, balance, as reported in the financial statements in Note 8.A. was overstated by $1.6 billion, and disclosures about inventory in Note 8.A. of the financial statements were significantly distorted (finding A).

Cost of Goods Sold model calculations to realize holding gains and losses on sales of depot-level reparables were inappropriate. As a result, we were not able to verify the reasonableness of holding gains and losses realized during FY 1999. Therefore, the Inventory, Net, balance was understated by an undeterminable amount (finding B).

Journal entries that the Naval Supply Systems Command recorded in the DFAS Central Data Base to revalue inventory from standard price to latest acquisition cost or net realizable value were erroneous. As a result, the estimated cost to repair unserviceable inventory was understated by approximately $209.7 million, and the latest acquisition cost for in-transit inventory was overstated by $81.6 million. In addition, supplemental information that the Naval Supply Systems Command provided to DFAS Cleveland Center for disclosure of war reserve material excluded certain military contingency stocks. As a result, the disclosure about war reserve material was understated by $67.7 million (finding C).

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) and the Director, DFAS, modify the Cost of Goods Sold model computations to comply with DoD Regulation 7000.14-R and issue guidance to recognize revenue for all reparable exchange price sales based at the standard price.

We recommend that the Director, DFAS, modify calculations of the potential loss related to excess, obsolete, and unserviceable inventory. We further recommend that DFAS modify procedures for using the Cost of Goods Sold model to restate inventory at standard price at the beginning of the accounting period; correctly reclassify appropriate inventory as inventory held for future sale or repair; accurately allocate cost recovery elements between inventory categories; and record the necessary prior period adjustments to correctly restate inventory as of the end of FY 1999.

We recommend that the Commander, Naval Supply Systems Command, and the Director, DFAS, establish procedures for the Naval Supply Systems Command to provide DFAS with the additional information needed for accurate disclosures about inventory held in reserve for future sale. We further recommend that the Commander, Naval Supply Systems Command, modify the revaluation spreadsheets to accurately calculate the estimated cost to repair unserviceable inventory, accurately classify the estimated cost to repair unserviceable inventory in-transit from customers, correctly calculate the cost of all war reserve material for footnote disclosure, and establish controls to detect clerical errors made during manual entry of data.

Management Comments. The Under Secretary of Defense (Comptroller) proposed alternative actions to overcome the limitations of the latest acquisition cost method. His office will evaluate options for bringing inventory accounting into full compliance with the Federal accounting standards. In subsequent discussions with Comptroller staff, they emphasized their desire to move toward the historical cost method for presentation of inventory in the financial statements.

The Navy concurred with the recommendations and stated that the Naval Supply Systems Command modified inventory revaluation spreadsheets as recommended to calculate information needed for disclosure of inventory held in reserve for future sale, correctly calculate the estimated cost of repair for unserviceable inventory, calculate and disclose war reserves, and provide check totals to reduce manual errors.

DFAS deferred to the Under Secretary of Defense (Comptroller) all recommendations on computations in the Cost of Goods Sold model and stated that it will implement the model as directed. The Director concurred with the recommendations to reclassify economic retention stock, contingency retention stock, and war reserve material as inventory held for future sale and to reclassify all unserviceable stock as held for repair. See the findings for a complete discussion of management comments and the Management Comments section for the complete text of the comments.

Audit Response. The alternative actions proposed by the Under Secretary of Defense (Comptroller) and subsequent discussions with Comptroller staff represent a long-term proposal to use the historical cost method for the financial presentation of Inventory, Net. We support this significant change in policy and believe it will be in the best interest of DoD. We will continue to monitor and evaluate the value and presentation of inventory in the Navy Working Capital Fund financial statements to identify any major problems in the current process, and assist in the transition to historical cost. However, it will be several years until the necessary changes are implemented for the historical cost method. Thus, presentation and disclosures about inventory in the financial statements will not be reliable for years.

Table of Contents

Background

The audit was performed as part of our effort to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. This report is the fourth in a series of Inspector General, DoD, reports on the FY 1999 financial statements for the Department of the Navy (Navy) Working Capital Fund. See Appendix A for the other three reports.

Navy Working Capital Fund. The Navy Working Capital Fund finances nine primary activity groups, which provide support to the Navy and other authorized customers. The largest activity group is the Supply Management activity group, which includes Supply Management (Navy) and Supply Management (Marine Corps). This audit did not include a review of the Marine Corps portion of reported inventory. The Supply Management activity group reported an Inventory and Related Property, Net, balance of $15.8 billion, of which $15.2 billion was Inventory, Net.[1] Inventory, Net, represented about 67 percent of Navy Working Capital Fund assets.

Naval Supply Systems Command. The Navy Supply Systems Command (NAVSUP) manages inventories for the Navy portion of the Navy Working Capital Fund. The Navy Inventory Control Point and field organizations maintain logistical records supporting the general ledger account balances in the Central Data Base (CDB). Each month, the NAVSUP computes and records adjustments in the CDB to revalue inventory from standard price to latest acquisition cost, to reduce the value of unserviceable inventory by the estimated cost to repair the inventory, and to revalue potential excess inventory to net realizable value.

Defense Finance and Accounting Service. The Defense Finance and Accounting Service (DFAS) serves as the accountant for the Navy Working Capital Fund. The DFAS Cleveland Center receives financial information in various forms from Navy Supply Management activity group organizations and records the data into the CDB accounting system. The annual financial statement for the Supply Management activity group is included in the Navy Working Capital Fund financial statements, which are included in the DoD Agency-Wide financial statements.

Policy for Valuation of Inventory

Federal Government Accounting Policy. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," October 27, 1993, established the policy on inventory valuation for Federal Government entities. Accounting Standard No. 3 states that inventory should be valued at latest acquisition cost or historical cost, except for excess, obsolete, and

[1]"Inventory, Net" is the term used in the financial statements in Note 8.A. that refers to inventory amounts in various categories after adding or deducting allowable gains or losses.

unserviceable inventory and inventory held for repair, which should be valued at net realizable value. Accounting Standard No. 3 provides two methods for valuing inventory held for repair: the allowance method and the direct method. The Navy Working Capital Fund uses the allowance method. Accounting Standard No. 3 states the following:

> Under the allowance method, inventory held for repair shall be valued at the same value as a serviceable item, however, an allowance for repairs contra-asset account shall be established. The annual credits required to bring the repair allowance to the current estimated cost of repairs shall be recognized as current period operating expenses. As the repairs are made the cost of repairs shall be charged (debited) to the allowance for repairs account.

DoD Accounting Policy. DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume 11B, chapter 55, "Supply Management Operations," December 1994, establishes the accounting policy for DoD Components to use in reporting inventory balances on their financial statements. DoD Regulation 7000.14-R provides that except for excess, obsolete, and beyond-economical-repair inventory, inventory should be valued at its latest acquisition cost, applying the last representative procurement price to all like items. Excess, obsolete, and beyond-economical-repair inventory should be valued at net realizable value. Net realizable value is the current salvage rate, expressed as a percentage of latest acquisition cost. The salvage rate is developed by the Deputy Under Secretary of Defense (Logistics) based on data derived from the Defense Reutilization and Marketing Service.

Objectives

The overall audit objectives were to determine whether the revaluation of inventory from standard price to an estimation of historical cost was reasonable and to evaluate the processes and procedures that NAVSUP and DFAS used to revalue inventory. We limited our review to the revaluation of inventory because Navy Working Capital Fund management had not executed management control tests of inventory record accuracy and completeness required for management assertions concerning inventory amounts reported in the financial statements. We also reviewed management controls and compliance with laws and regulations related to those objectives. Appendix A discusses the audit scope and methodology and our review of the management control program.

A. Cost of Goods Sold Model

Calculations in the Cost of Goods Sold (COGS) model did not follow Federal accounting standards or DoD guidance for the presentation and disclosure of inventory in the FY 1999 Navy Working Capital Fund financial statements. The calculations did not follow standards or guidance because computations in the model that the Under Secretary of Defense (Comptroller) and DFAS designed were incorrect, and because DFAS Cleveland Center operational guidance for executing the model was inappropriate or used incomplete information. As a result, the Inventory, Net, balance reported in the FY 1999 Navy Working Capital Fund financial statements was overstated by $1.6 billion, and the disclosures about inventory in Note 8.A. of the financial statements were significantly distorted.

COGS Model

Navy Working Capital Fund logistical and accounting systems record inventory transactions and account for inventory at standard price. Because those logistical and accounting systems cannot value inventory at historical cost or latest acquisition cost, in compliance with Statement of Federal Financial Accounting Standards No. 3, the Under Secretary of Defense (Comptroller) (USD[Comptroller]) and DFAS developed a COGS model, which has been used since FY 1995. The process to revalue inventory from standard price to an estimation of historical cost for financial reporting is complex and involves computations by both NAVSUP and DFAS Cleveland Center. The COGS model is a series of excel spreadsheets to revalue inventory from standard price to historical cost, calculate cost of goods sold for the period, and produce information required for the disclosures in the financial statements about inventory. The post-closing trial balance from the COGS model was used for the preparation of the FY 1999 Navy Working Capital Fund financial statements. The revaluation of inventory was accomplished by recording 20 journal entries to the COGS model trial balance for the Navy Supply Management activity group. Those journal entries included the following types of adjustments:

- reversing entries to restate inventory to standard price at the beginning of FY 1999;

- adjusting entries to realize holding gains and losses related to inventory sales, disposals, and transfers; to reclassify inventory into categories for disclosure purposes; and to revalue inventory from standard price to latest acquisition cost or net realizable value at the end of FY 1999; and

- closing entries to close the accounting records at the end of the period.

Followup on Naval Audit Service Work

Naval Audit Service (NAS) Report No. N2000-0014, "Department of the Navy Working Capital Fund Inventory Records and Valuation," December 30, 1999, reports that the COGS model used for the FY 1998 financial statements contained errors, used inappropriate accounts, and used outdated inventory stratification data. The report identifies erroneous data used in the model, policy issues requiring guidance from the USD(Comptroller) and DFAS, and deficiencies in the design and execution of the model that caused misstatements of the Inventory, Net, balance. The NAS recommended numerous actions to improve inventory valuation, including recommendations to modify the design and execution of the COGS model to implement the requirements of Statement of Federal Financial Accounting Standards No. 3.

DFAS Cleveland Center did not implement the recommendations to modify the COGS model because its personnel interpreted correspondence from DFAS Headquarters to prohibit any modification to the model before the USD(Comptroller) issued revised guidance.

Computations of Potential Loss Related to Excess, Obsolete, and Unserviceable Inventory

Computations in the COGS model, which the USD(Comptroller) and DFAS designed, incorrectly calculated information used for the journal entries to recognize the potential loss related to excess, obsolete, and unserviceable material and the value of inventory at latest acquisition cost. DoD Regulation 7000.14-R, volume 11B, chapter 55, provides that the difference between the standard price and net realizable value of excess, obsolete, and unserviceable material should be recognized as a loss in the accounting period. The regulation also provides that the value of inventory held for sale, inventory held in reserve for future sale, and inventory held for repair should be adjusted to latest acquisition cost.

The computations in the COGS model of the potential loss related to excess, obsolete, and unserviceable material calculated the loss as the difference between the latest acquisition cost of the material and its net realizable value instead of the difference between standard price and net realizable value. That calculation understated the potential loss by the difference between the standard price and latest acquisition cost of the material. As a result, inventory reported in the FY 1999 Navy Working Capital Fund financial statements was overstated, and program costs were understated.

Operational Procedures for Execution of the COGS Model

DFAS Cleveland Center's operational procedures for execution of the model, "Draft Reporting Procedures for Using the COGS Model," did not provide for proper inventory revaluation. The operational procedures provided guidance for calculating and recording journal entries in the COGS model. The guidance caused erroneous journal entries to do the following:

- restate inventory at standard price at the beginning of FY 1999,
- reclassify inventory as held in reserve for future sale and held for repair, and
- allocate cost recovery elements between inventory categories.

Restating Inventory at Standard Price. NAS Report No. N2000-0014 reports that the guidance for the reversing entry was erroneous. However, DFAS Cleveland Center did not modify the guidance for executing the model and did not process accounting adjustments to correct the erroneous COGS account balances at the beginning of FY 1999. Not processing the correct adjustments caused a significant imbalance between the inventory account balances in the COGS model and the CDB general ledger account balances. To correct the misstatement at the beginning of FY 1999, DFAS Cleveland Center should have recorded the prior period adjustment in the COGS model to restate the inventory account balances shown in Table 1.

Table 1. Prior Period Adjustment to COGS Model at the Beginning of FY 1999

General Ledger Account	Debit Amount	Credit Amount
Inventory held in reserve for future sale	$ 9,489,070	
Excess, obsolete, and unserviceable inventory	22,166,889	
Allowance for holding gains and losses	6,542,125,137	
Cumulative results of operations	420,791,373	
Inventory held for sale		$ 732,005,400
Inventory held for repair		6,262,567,069

Failure to record the adjustment exacerbated the misstatement of Inventory, Net, and the cost of goods sold in FY 1999. DFAS Cleveland Center needs to make an additional adjustment to COGS model account balances identified in Table 2 to bring the COGS model into agreement with the CDB general ledger accounts at the end of FY 1999.

Table 2. Adjustment to COGS Model Account Balances at the End of FY 1999

General Ledger Account	Debit Amount	Credit Amount
Inventory held for sale	$ 1,013,277,320	
Inventory held in reserve for future sale	9,489,070	
Allowance for holding gains and losses	3,014,953,590	
Cumulative results of operations	691,888,856	
Excess, obsolete, and unserviceable inventory		$ 23,784,514
Inventory held for repair		4,705,824,322

To restate Inventory, Net, correctly for the FY 2000 financial statements, DFAS should make both adjustments shown in Tables 1 and 2.

Reclassification of Inventory as Held in Reserve for Future Sale and Held for Repair. The CDB does not account for inventory as held in reserve for future sale or inventory held for repair. To overcome that limitation, the COGS model includes journal entries to reclassify inventory to those categories. However, DFAS Cleveland Center's operational procedures caused it to use incomplete information.

Inventory Held in Reserve for Future Sale. DoD Regulation 7000.14-R, volume 11B, chapter 55, provides that inventory held in reserve for future sale should include the value of inventory stratified as economic retention stock and contingency retention stock. NAS Report No. N2000-0014 reports that NAVSUP and DFAS Cleveland Center did not establish procedures to ensure that DFAS Cleveland Center received accurate information to reclassify economic and contingency retention stock as inventory held in reserve for future sale.

NAVSUP calculated the value of economic and contingency retention stock using information from the March 31, 1999, Central Secondary Item Stratification. Although the information needed for disclosure about inventory held in reserve for future sale was readily available from the NAVSUP Central Secondary Item Stratification, DFAS Cleveland Center did not request and NAVSUP did not provide the necessary information at the end of FY 1999. In addition, finding C of this report discusses how NAVSUP did not provide accurate or complete data for the reclassification of war reserve stocks as inventory held in reserve for future sale.

Inventory Held for Repair. DoD Regulation 7000.14-R, volume 11B, chapter 55 provides that inventory held for repair should include the value of material in unserviceable condition (condition codes F, G, M, Q, and R). Navy logistics systems report condition code changes to the accounting system. However, the CDB did not maintain general ledger accounts to capture inventory values for each condition code. The CDB maintains general ledger accounts for inventory on-hand and inventory inducted to repair. The CDB correctly classifies inventory inducted to repair (condition code M) as inventory held for repair. In addition to the general ledger data, the logistics systems aggregate and report values for serviceable material and categories of unserviceable material using database codes. Database code "90611" represents the value of serviceable material, database code "90613" represents the value of unserviceable material awaiting parts (condition code G), and database code "90612" represents the value of all other unserviceable material (condition codes F, Q, and R).

DFAS Cleveland Center's operational procedures specify that information recorded for database code 90612 be used to reclassify inventory from held for sale to held for repair. Execution of the procedures resulted in incomplete reclassification of inventory from held for sale to held for repair because DFAS did not include the value recorded for database code 90613 (unserviceable material awaiting parts) in the entry to reclassify inventory as held for repair. On September 30, 1999, the Navy held $754 million of condition code G material. Exclusion of the condition code G material caused inventory held for sale to be overstated and inventory held for repair to be understated.

Allocation of Cost Recovery Elements Between Inventory Categories. NAS Report No. N2000-0014 reports that the DFAS Cleveland Center operational procedures for executing the COGS model incorrectly calculated the allocation of cost recovery elements between inventory categories. Journal entries recorded in the COGS model to allocate the potential loss on excess, obsolete, and unserviceable inventory and the reduction from standard price to latest acquisition cost erroneously allocated reductions to inventory held for sale instead of inventory held for repair.

Other Information and Calculations Affecting Presentation and Disclosures About Inventory. Finding C of this report discusses erroneous calculations of accounting adjustments that NAVSUP recorded in the CDB. Those accounting adjustments caused Inventory, Net to be overstated by $209.7 million.

Inspector General, DoD, Report No. D-2000-140, "Compilation of the FY 1999 Department of the Navy Working Capital Fund Financial Statements," June 7, 2000, reports that Inventory, Net was overstated by $44.9 million because the DFAS Cleveland Center and Navy Working Capital Fund organizations did not reconcile general ledger account balances in the CDB with financial inventory control ledgers that field organizations maintained and because CDB general ledger account balances were erroneously classified as inventory. The report also indicates that inventory may be overstated by as much as $445.4 million[2] because the CDB general ledger account for inventory in-transit from customers was not reconciled to supporting records.

[2]In response to the report, DFAS agreed that inventory was overstated by $436.3 million because residual balances were not cleared. DFAS indicated that an accounting entry would be made in FY 2000 to eliminate the residual balances.

Summary

Table 3 compares the value of inventory, at latest acquisition cost, calculated in the COGS model with the value as adjusted for corrections discussed in this finding.

Table 3. Comparison of Inventory and Related Accounts Computed in the COGS Model With Values Computed by Audit
(dollars in thousands)

Inventory Category	Computed by COGS Model	Computed by Audit	Difference
Held for Sale	$13,766,395	$8,533,963	$5,232,432
Held in Reserve for Future Sale	85,335	1,766,458	(1,681,123)
Held for Repair	8,843,378	8,748,304	95,074
Excess, Obsolete, and Unserviceable	130,960	107,176	23,784
Subtotal of inventory at latest acquisition cost	**22,826,068**	**19,155,901**	**3,670,167**
Allowance for holding gains and losses	(9,192,328)	(7,138,648)	(2,053,680)
Inventory, Net	**$13,633,740**	**$12,017,253**	**$1,616,487**

Correctable errors in the design of calculations in the COGS model and errors in DFAS Cleveland Center's procedures for executing the model caused Inventory, Net, to be overstated by $1.6 billion. Inventory, Net, will continue to be misstated until the USD(Comptroller) issues revised policy for computing inventory and until policy changes are implemented. The USD(Comptroller) needs to direct the correction of COGS model calculations for excess, obsolete, and unserviceable material and for inventory at latest acquisition cost, and DFAS Cleveland Center needs to revise operational procedures for executing the model.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Under Secretary of Defense (Comptroller) and the Director, Defense Finance and Accounting Service, modify the computations of the potential loss for excess, obsolete, and unserviceable inventory and the value of inventory at latest acquisition cost adjustment to comply with chapter 55, volume 11B, DoD Regulation 7000.14-R.

USD(Comptroller) Comments. The USD(Comptroller) proposed alternative actions to overcome the limitations of the latest acquisition cost method. The USD(Comptroller) proposes to concentrate on evaluating the policy and systems changes that would be required to implement and support a latest acquisition cost valuation method and a direct cost historical valuation method. In subsequent conversations with USD(Comptroller) personnel, they emphasized their desire to move toward the historical cost method for the financial presentation of inventory in financial statements for DoD organizations. In addition, the USD(Comptroller) requested the audit community's assistance in identifying the minimum changes recommended to improve financial presentation of inventory using the latest acquisition cost method.

DFAS Comments. DFAS concurred with the intent and theory of the recommendation. However, DFAS stated that the Accounting Policy Directorate in USD(Comptroller) is responsible for providing adequate documentation and guidance for the COGS model to ensure it is consistent with DoD Regulation 7000.14-R, including guidance for valuing excess, obsolete, and unserviceable inventory.

Audit Response. The alternative actions proposed by the USD(Comptroller) and subsequent discussions with Comptroller staff represent a long-term proposal to use the historical cost method for the financial presentation of Inventory, Net. We support this significant change in policy and believe it will be in the best interest of DoD. The latest acquisition cost method currently used by DoD is extremely complicated, contains numerous deficiencies, and is simply not practical. Based on the proposed change in direction by the USD(Comptroller), we will continue to monitor and evaluate the value and presentation of inventory in the Navy Working Capital Fund financial statements to identify any major problems in the current process, and assist in the transition to historical cost. However, it will be years until the necessary policy and systems changes are implemented for the historical cost method. As a result, the presentation and disclosures about inventory in the financial statements will not be reliable for years.

Policy and system changes needed to improve the presentation and disclosures related to inventory for the Navy Working Capital Fund are contained in this report and NAS Report No. N2000-0014. Auditors from the Inspector General, DoD; NAS; and the General Accounting Office will continue to participate with the Navy Logistics Working Group to identify accounting system changes needed to capture financial information at the transaction level and improve presentation and disclosures.

A.2. We recommend that the Director, Defense Finance and Accounting Service, modify operational procedures for executing the Cost of Goods Sold model to:

a. Restate inventory at standard price at the beginning of the fiscal year.

b. Classify economic retention stock, contingency retention stock, and war reserve material as inventory held for future sale.

c. Classify material in G condition code as inventory held for repair.

d. Use correct allocations in journal entries to recognize the potential loss on excess, obsolete, and unserviceable inventory and to reduce inventory from standard price to latest acquisition cost between the inventory categories.

DFAS Comments. DFAS deferred to the USD(Comptroller) for Recommendations 2.a. and d. on computations in the Cost of Goods Sold model, stating that it will implement the model as directed. DFAS concurred with Recommendations 2.b. and c. and agreed by September 2000 to reclassify economic retention stock, contingency retention stock, and war reserve material as inventory held for future sale and to reclassify condition code G stock as held for repair.

A.3. We recommend that the Director, Defense Finance and Accounting Service, calculate and record the prior period adjustment to restate inventory at the end of FY 1999. The adjustment is needed to correct misstatements that have occurred since FY 1995 because of erroneous calculations and to eliminate imbalances between the Cost of Goods Sold model and the Central Data Base identified in Tables 1 and 2 of this report.

DFAS Comments. DFAS deferred to the USD(Comptroller) for all recommendations on computations in the Cost of Goods Sold model, stating that it will implement the model as directed.

A.4. We recommend that the Commander, Naval Supply Systems Command, and the Director, Defense Finance and Accounting Service, establish procedures for the Naval Supply Systems Command to provide the Defense Finance and Accounting Service with the additional information needed for accurate disclosure of inventory held in reserve for future sale.

Navy Comments. NAVSUP concurred and stated that it established control procedures in coordination with DFAS Cleveland Center to direct all requests for necessary information to a specific department in NAVSUP.

DFAS Comments. DFAS concurred, and DFAS Cleveland Center will work with NAVSUP to establish procedures to ensure that NAVSUP provides DFAS with the additional information needed for accurate reporting of inventory held in reserve for future sale. DFAS planned to complete the corrective actions by September 2000.

B. Revenue Recognition and Realization of Holding Gains and Losses

Cost of Goods Sold (COGS) model calculations to realize holding gains and losses on sales of depot-level reparables were inappropriate. The calculations were inappropriate because they incorrectly assumed that the sales price for depot-level reparable items was always standard price. However, approximately 37 percent of the revenue for the Navy Working Capital Fund was recognized at the exchange price.[3] As a result, we were not able to verify the reasonableness of holding gains and losses realized during FY 1999, which caused Inventory, Net, to be understated by an undeterminable amount.

Inventory Reporting

Inventory is reported on the financial statements at its latest acquisition cost less the allowance for unrealized gains and losses so that the net of the inventory and allowance will yield an approximation of historical cost. Holding gains and losses result, in part, from changes in the value of inventory because of increases or decreases in the latest acquisition cost during the period that inventory is held. At the end of the each fiscal year, the COGS model calculates a ratio of the holding gains and losses to inventory at standard price (realization ratio). The realization ratio is used in calculations to relieve the allowance for holding gains and losses related to inventory that has been sold, transferred to non-Navy Working Capital Fund organizations without reimbursement, or otherwise disposed of during the fiscal year.

Realization of Holding Gains and Losses on Inventory Sales

The USD(Comptroller) and DFAS designed the COGS model calculation of the realization ratio. That calculation has been used in the COGS model since FY 1995. The realization ratio was calculated as holding gains and losses divided by inventory available for sale, at standard price. The realization ratio for FY 1999 (57.7 percent) was applied to Navy Working Capital Fund inventory sales during the fiscal year. Based on the calculation, the COGS model realized \$3.1 billion of holding gains and losses.

Navy Working Capital Fund Inventory Sales. Navy Working Capital Fund inventory sales, however, included sales at standard price, at exchange price, and at carcass price (standard price less exchange price). The sales price of a depot-level reparable item is dependent on whether the customer returns an unserviceable item. Sales of depot-level reparable items made without the return of an unserviceable item are priced at the standard price of the item. Sales of depot-level

[3]The exchange price is the estimated repair price plus cost recovery elements billed to the customer as part of a sales transaction for a depot-level reparable item when the customer returns an unserviceable asset.

reparable items for which the customer indicates that an unserviceable item will be returned are priced at the exchange price of the item. The difference between the standard price and the exchange price approximates the carcass price of the item. When a customer does not return the unserviceable item that was expected, the customer is also charged the carcass price in addition to the exchange price.

Table 4 identifies Navy Working Capital Fund inventory sales at standard price, exchange price, and carcass price.

Table 4. Navy Working Capital Fund Revenue From Inventory Sales
(dollars in thousands)

Revenue from Sale of Inventory at Standard Price	$3,343,025
Revenue from Sale of Inventory at Exchange Price	2,032,551
Revenue from Sale of Inventory at Carcass Price	64, 043
Total	**$5,439,619**

Application of the realization ratio to exchange price revenue is inappropriate. The realization ratio should only be applied to standard price revenue.

Estimated Impact of Exchange Price Sales on Holding Gains and Losses. The exchange price for a depot-level reparable item approximates the estimated cost to repair the item when it is unserviceable plus the cost recovery elements used in the standard price calculation, plus cost recovery elements for carcass attrition (unserviceable assets that cannot be repaired) and shipping and transportation. The average or composite estimated repair costs in the March 31, 1999, Central Secondary Item Stratification were 24.7 percent for shipboard depot-level reparable items and 16.7 percent for aviation depot-level reparable items. If revenue for depot-level reparable exchanges was measured at standard price, the total revenue for Navy Working Capital Fund inventory sales would increase from $5.4 billion to $15.1 billion. Application of the realization ratio (57.7 percent) to the increased revenue would have realized an additional $5.6 billion ($15.1 billion less $5.4 billion x 57.7 percent) of holding gains and losses.

Summary

The application of the realization ratio, based on standard price, to exchange price revenue is inappropriate. Application of the realization ratio to exchange price sales understated the holding gains and losses that were realized during the fiscal year. As a result, the allowance for holding gains and losses was overstated and Inventory, Net, was understated.

We do not believe that the calculation of a separate realization rate for exchange price sales is feasible or desirable. Instead, the Navy Working Capital Fund should recognize noncash revenue equal to the carcass value of assets returned as part of the exchange. Under that approach, all revenue would be recognized at standard price.

A reasonable and supportable estimate of the historical cost of Navy Working Capital Fund inventory is not currently available. Such an estimate would not be available until the USD(Comptroller) issues guidance for the revenue recognition and realization of holding gains and losses on depot-level reparable exchange price sales, and until the Navy Working Capital Fund and DFAS calculate the ending balance of the allowance for holding gains and losses at the end of FY 1999. The calculation would involve the recalculation of holding gains and losses realized between FY 1995 and FY 1999 and would result in a prior period adjustment to restate Inventory, Net.

Recommendations, Management Comments, and Audit Response

Revised Recommendation. As a result of management comments, we revised draft Recommendation B.2. to indicate that DFAS was primarily responsible for recalculating the ending balance of the allowance for holding gains and losses, but that NAVSUP would have to provide assistance.

B.1. We recommend that the Under Secretary of Defense (Comptroller) develop supplemental guidance on revenue recognition for depot-level reparable exchange price sales. The guidance should prescribe recognition of noncash revenue equal to the carcass value of unserviceable assets returned as part of the exchange transaction. (The change would result in all revenue being recognized at standard price.) The guidance should also direct the related changes in the design of the Cost of Goods Sold model for the Navy Working Capital Fund.

Management Comments. The USD(Comptroller) proposed alternative actions to overcome the limitations of the latest acquisition cost method, specifically, to concentrate on evaluating the policy and systems changes that would be required to implement and support a latest acquisition cost valuation method and a direct historical cost valuation method. USD(Comptroller) personnel in subsequent conversations also stated their desire to move toward the historical cost method of presentation of inventory.

Audit Response. We accept the proposed alternative actions, and support the significant change in policy to move toward historical costs. However, the proposed alternative actions represent a long-term solution to improve the financial presentation of Inventory, Net. It will be years until those evaluations are completed and necessary policy and systems changes implemented, the presentation and disclosures about inventory in the financial statements will not be reliable.

B.2. We recommend that the Defense Finance and Accounting Service, with support from the Commander, Naval Supply Systems Command, recalculate

the ending balance of the allowance for holding gains and losses based on supplemental guidance that the Under Secretary of Defense (Comptroller) is to issue in Recommendation B.1. for revenue recognition and realization of holding gains and losses.

Navy Comments. The NAVSUP concurred in principle, stating agreement that the ending balance of the allowance for holding gains and losses should be recalculated to accurately reflect revenue recognition for depot-level-reparable exchange price sales. However, NAVSUP stated that the recalculation is the responsibility of DFAS Cleveland Center and could not be accomplished until the Under Secretary of Defense (Comptroller) issues supplemental guidance on revenue recognition for depot-level reparables.

DFAS Comments. DFAS deferred to the USD(Comptroller) for all recommendations on computations in the Cost of Goods Sold model, stating that it will implement the model as directed.

C. Calculations Affecting the Presentation and Disclosure of Inventory

Journal entries that NAVSUP recorded in the CDB to revalue inventory from standard price to latest acquisition cost or net realizable value were erroneous. In addition, supplemental information that NAVSUP provided to DFAS Cleveland Center for war reserve material excluded certain military contingency stock. The journal entries contained errors because the NAVSUP revaluation spreadsheets erroneously calculated the estimated cost to repair unserviceable inventory and included the estimated cost to repair in-transit inventory in the latest acquisition cost adjustment. Also, controls were not in place to detect clerical errors. The incomplete information on war reserve material occurred because NAVSUP misinterpreted DoD guidance. As a result, the reported estimated cost of $1.9 billion to repair unserviceable inventory was understated by approximately $209.7 million, and the latest acquisition cost adjustment of $346.5 million for in-transit inventory was overstated by $81.6 million. Also, the Navy Working Capital Fund disclosure of the latest acquisition cost for war reserve material was understated by $67.7 million.

NAVSUP Adjustment Calculations

The NAVSUP revaluation spreadsheets were originally designed by the USD(Comptroller), NAVSUP, and DFAS. The spreadsheet calculations were used to prepare journal entries, recorded in the CDB, which provided information used in the COGS model. However, the spreadsheet calculations produced incorrect information for the estimated cost to repair unserviceable inventory and cost to repair in-transit inventory. Also, NAVSUP did not establish controls to detect and prevent erroneous data entry.

Estimated Cost to Repair Unserviceable Inventory. NAVSUP developed a repair cost ratio using information from the March 31, 1999, Central Secondary Item Stratification (CSIS). The CSIS included a forecast of the cost-to-repair inventory at both standard price and estimated actual repair price. NAVSUP applied the repair cost ratio to the value of unserviceable inventory on September 30, 1999, to calculate the estimated cost to repair unserviceable inventory. However, the CSIS values used to calculate the repair cost ratio were based on the portion of unserviceable inventory that NAVSUP planned to repair during FY 2000 rather than the total unserviceable inventory that required repair. The objective of the calculation was to estimate the cost to repair all unserviceable inventory. Accordingly, NAVSUP should have based the ratio on total unserviceable inventory on September 30, 1999. As a result, the NAVSUP calculation of the repair cost ratio understated the ratio and, accordingly, understated the estimated cost to repair unserviceable inventory by $209.7 million.

In-Transit Inventory. In-transit inventory consists of serviceable inventory being delivered by vendors, serviceable inventory being returned from DoD sources, and unserviceable inventory being returned from Navy customers. The spreadsheet calculations recognized that a portion of the in-transit inventory was not in serviceable condition and separately calculated the estimated cost to repair that inventory. However, the spreadsheets incorrectly included the estimated cost to repair in-transit inventory in the journal entry to reduce inventory from standard price to latest acquisition cost instead of the journal entry to reduce unserviceable inventory by the estimated cost of repair. As a result, NAVSUP journal entries understated the estimated cost to repair unserviceable inventory and overstated the difference between standard price and latest acquisition cost by $81.6 million.

Clerical Errors. NAVSUP personnel made at least six clerical errors during the entry of the CSIS data into the revaluation spreadsheets. For example, NAVSUP entered $34.8 million as the value of contingency retention stock for shipboard repairable items instead of $345.8 million. The errors occurred because NAVSUP did not establish controls to detect erroneous data entry. The process of manually entering data from the CSIS to the revaluation spreadsheets is subject to human error, especially if data entry controls, such as control totals, are not in place. In the case of the CSIS data, the clerical errors did not cause the total inventory to be misstated, but the categorization of inventory for financial disclosure purposes was incorrect. As a result, the errors caused the Navy Working Capital Fund disclosures about inventory in Note 8.A. of the financial statements to be distorted because the inventory was included in the wrong inventory category.

War Reserve Material

Note 8.A. of the FY 1999 Navy Working Capital Fund financial statements classified inventory into categories of inventory available for resale; inventory held in reserve for future sale; inventory held for repair; and excess, obsolete, and unserviceable inventory. In addition, Note 8.A. reported that $26.5 million of inventory available for resale, valued at latest acquisition cost, was held as war reserve material. The NAVSUP calculated the information for the disclosure about war reserve material and provided it as supplemental information to DFAS Cleveland Center. However, the information that NAVSUP provided understated the value of war reserve material by approximately $67.7 million because NAVSUP misinterpreted guidance in DoD Regulation 7000.14-R, volume 6B, chapter 10.

As discussed in this finding, NAVSUP spreadsheets developed ratios of inventory in different strata based on the CSIS. The ratios were distorted because NAVSUP did not implement the guidance for military contingency stocks in the DoD Regulation 7000.14-R, volume 11B, chapter 55. DoD Regulation 7000.14-R specifies that inventory held in reserve for future sale should consist of stocks maintained as economic and contingency retention stock. DoD Regulation 4140.1-R, “DoD Material Management Regulation,” May 1998, provides that contingency retention stock includes stocks retained for military contingency.

The March 31, 1999, CSIS included the following four categories of inventory retained for military contingencies (war reserve material):

- protected prepositioned war reserve material,
- protected other acquisition war reserve material,
- balance prepositioned war reserve material, and
- balance other acquisition war reserve material.

The NAVSUP calculations incorrectly classified the first three categories of war reserve material as inventory available for resale, and they classified the fourth category as war reserve material. The classifications distorted the values of inventory available for resale and inventory held in reserve for future sale in the notes to the financial statements and understated the disclosure about war reserve material by $67.7 million.

Recommendations, Management Comments, and Audit Response

C. We recommend that the Commander, Naval Supply Systems Command, modify the Naval Supply Systems Command revaluation spreadsheets to:

1. Calculate the estimated cost to repair unserviceable inventory using a ratio based on total unserviceable inventory.

2. Include the estimated cost to repair unserviceable in-transit inventory in the adjustment to record the estimated cost to repair unserviceable inventory instead of in the latest acquisition cost adjustment.

3. Establish controls to detect clerical errors during the manual entry of data in the spreadsheets.

4. Calculate the value of war reserve material for footnote disclosure to include all inventory retained for military contingencies.

Navy Comments. NAVSUP concurred and modified the inventory revaluation spreadsheets as recommended to correctly calculate the estimated cost to repair unserviceable inventory and to calculate and disclose war reserves using all four categories of inventory retained for military contingencies. NAVSUP also modified the spreadsheets to provide check totals with necessary links, and NAVSUP personnel are verifying data input against source documentation to prevent clerical error during manual entry of data.

Appendix A. Audit Process

Scope

Work Performed. During this part of our audit of the FY 1999 Navy Working Capital Fund financial statements, we evaluated the valuation and presentation of inventory on the financial statements. The FY 1999 Navy Working Capital Fund financial statements reported total assets of $23.4 billion and total liabilities of $5.5 billion. Net program costs for the Navy Working Capital Fund were $710.9 million. Inventory is the most significant asset of the Navy Working Capital Fund and comprised $15.2 billion, or about 67 percent of Navy Working Capital Fund assets. We conducted separate audit work on the revaluation of inventory because prior audit work had rated inventory as a high-risk area for misstatement of the financial statements. We included tests of management controls considered necessary.

Limitations to Audit Scope. Our audit work was limited to an examination of the Naval Supply System Command's and DFAS Cleveland Center's processes, procedures, and management controls for revaluing inventory from standard price to an estimation of historical cost. We did not review procedures to value inventory reported for the Marine Corps. We also limited our review to the revaluation of inventory because Navy Working Capital Fund management had not executed management control tests of inventory accuracy and completeness required for management assertions concerning inventory amounts reported in the financial statements.

Because we did not obtain the final version of the financial statements in a timely manner, we were unable to recommend adjustments to the FY 1999 Navy Working Capital Fund financial statements. Therefore, the recommendations in this report should be considered in preparing the FY 2000 financial statements of the Navy Working Capital Fund.

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, subordinate performance goal, and performance measures:

> **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 2.5.1:** Reduce the number of noncompliant accounting and finance systems. **(01-DoD-2.5.1.)**

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 objective and goal.

Financial Management Area. Objective: Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers' Financial Integrity Act. **(FM-5.3)**

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

Methodology

Our review of the revaluation of inventory from standard price to an estimation of historical price covered the processes that NAVSUP and DFAS Cleveland Center used to execute the revaluation. NAVSUP entered data from the March 31, 1999, Central Secondary Item Stratification and trial balance data from the CDB into excel spreadsheets to calculate adjustments recorded in the CDB. The DFAS Cleveland Center executed the revaluation in the DFAS COGS model designed by the USD(Comptroller) and DFAS. The COGS model is a series of excel spreadsheets used to revalue inventory and calculate cost of goods sold for the financial statements. The COGS revaluation process involves a series of calculations that are recorded in journal entries. Our review focused on the accuracy and propriety of the data used in the NAVSUP and DFAS calculations.

Computer-Processed Data. Using the Uniform Inventory Control Point system, NAVSUP produced Central Secondary Item Stratification reports showing the stratification of Navy Working Capital Fund inventory into different categories. We did not evaluate the stratification process, nor did we evaluate the general or application controls over the Uniform Inventory Control Point system. We concluded that the data were sufficiently reliable to meet the audit objective. Not evaluating the controls did not affect the results of the audit.

Audit Type, Period, and Standards. We performed this financial related audit from March 24, 1999, through March 15, 2000, in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

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

Management Control Program

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the management controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DFAS Cleveland Center management controls over the Cost of Goods Sold model. The audit also reviewed management's self-evaluation of the applicable management controls

Adequacy of Management Controls. We identified material management control weaknesses as defined by DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996. Management controls at DFAS Cleveland Center were not adequate to ensure that the presentation and disclosures about inventory in the FY 1999 Navy Working Capital Fund financial statements were reasonable. Recommendations A.2. and A.4., if implemented, will improve the presentation and disclosure of inventory in the financial statements. A copy of this report will be provided to the senior official in charge of management controls for DFAS Cleveland Center.

Adequacy of Management's Self-Evaluation. Managers at DFAS Cleveland Center identified Navy Working Capital Fund supply management as an assessable unit. One of the management controls identified was the area of desk operational procedures for the COGS model. However, DFAS Cleveland Center's latest assessment of Supply Management, published in May 1998, indicated that the desk operating procedures were adequate. The assessment did not identify the deficiencies discussed in this report.

Prior Coverage

The General Accounting Office and the Inspector General, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at http://www.gao.gov. Inspector General, DoD, reports can be accessed on the Internet at http://www.dodig.osd.mil/audit/reports.

The Inspector General, DoD, issued three other reports on the FY 1999 Navy Working Capital Fund financial statements:

- **Report No. D-2000-144**, "Compiling and Reporting FY 1999 Department of the Navy Working Capital Fund Intragovernmental Transactions," June 9, 2000

- **Report No. D-2000-140**, "Compilation of the FY 1999 Department of the Navy Working Capital Fund Financial Statements," June 7, 2000

- **Report No. D-2000-082**, "Inspector General, DoD, Oversight of the Naval Audit Service Audit of the FY 1999 Department of the Navy Working Capital Fund Financial Statements," February 14, 2000

The Naval Audit Service also issued a report on inventory valuation as part of its FY1998 audit coverage, as discussed in this audit report.

- **NAS Report No. N2000-0014**, "Department of the Navy Working Capital Fund Inventory Records and Valuation," December 30, 1999.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
    Director, Accounting Policy
  Deputy Comptroller (Program/Budget)
Director, Defense Logistics Studies Information Exchange

Department of the Army

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

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Naval Inspector General
Auditor General, Department of the Navy
Commander, Naval Supply Systems Command

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 Finance and Accounting Service
  Director, Defense Finance and Accounting Service Cleveland Center
Director, Defense Logistics Agency

Non-Defense Federal Organizations

Office of Management and Budget
General Accounting Office
  National Security and International Affairs Division
    Technical Information Center

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 Management, Information, and Technology, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform

Under Secretary of Defense (Comptroller) Comments

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

COMPTROLLER

JUL 27 2000

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

SUBJECT: Draft Audit Report on Revaluation of Inventory for the Fiscal Year 1999 Department of the Navy Working Capital Fund Financial Statements (Project No. D2000FC-0045.002) (Formerly Project No. 0FC-2113)

This is the Office of the Under Secretary of Defense (Comptroller) response to the Office of the Inspector General, Department of Defense draft report, "Revaluation of Inventory for the FY 1999 Department of the Navy Working Capital Fund Financial Statements," dated April 27, 2000 (Project No. D2000FC-0045.002) (formerly Project No. 0FC-2113).

Detailed comments on the specific findings and recommendations contained in the report are provided in the attachment.

The point of contact for this matter is Ms. Gretchen Anderson. She may be reached by e-mail: andersog@osd.pentagon.mil or by telephone at (703) 697-4691 (DSN 227-4691).

Nelson Toye
Nelson Toye
Deputy Chief Financial Officer

Attachment

OFFICE OF THE INSPECTOR GENERAL DRAFT AUDIT REPORT DATED APRIL 27, 2000 (PROJECT NO. D2000FC-0045.002) (FORMERLY PROJECT NO. 0FC-2113)

"THE REVALUATION OF INVENTORY FOR THE FY 1999 DEPARTMENT OF THE NAVY WORKING CAPITAL FUND FINANCIAL STATEMENTS"

* * * * *

UNDER SECRETARY OF DEFENSE (COMPTROLLER) COMMENTS

* * * * *

COMMENTS ON FINDING

The recommendations in the draft report pertain to the Department's existing inventory valuation method, which is based on adjusting latest acquisition cost (LAC) for holding gains and losses. This method, while it approximates historical cost, has recognized limitations due to the complexity and the periodicity of the calculation.

The Department proposes to revise its Implementation Strategy for attaining an auditable financial presentation of inventory and related property. The proposed revised strategy plan is to evaluate, with the assistance of firms of certified public accountants, the options for bringing inventory accounting and reporting into full compliance with the federal accounting standards. The evaluation would address both adjusted LAC and direct historical cost methods and identify the policy and information systems changes required to support these approaches. Depending on the outcome of the evaluation, the Department intends to develop a plan to implement the improvements to its systems and procedures that are needed to accomplish the recommended approach. Necessary policy and systems changes could require substantial investment and the efforts of the most knowledgeable functional, financial and inventory systems experts in the Department. The Department also is working actively to improve the record of its physical inventories, in part to support the existence and completion assertions for the financial presentation of inventory.

The evaluation of options may lead to a decision to use a method other than adjusted LAC and any attempt to bring the Department's current systems into full compliance could require a full commitment of existing personnel and significant budgetary resources. Therefore, the Department requests the audit community's assistance in identifying the minimum changes recommended to improve financial presentation of inventory using the adjusted LAC method. While physical inventory procedures are being improved, the Department proposes to concentrate its limited resources for valuation issues on supporting the evaluation of valuation options, as described above.

* * * *

Page 1 of 2 Attachment

COMMENTS ON RECOMMENDATIONS

RECOMMENDATION A.1.: The Office of the Inspector General, Department of Defense (OIG, DoD) recommended that the Under Secretary of Defense (Comptroller) (USD(C)) and the Director, Defense Finance and Accounting Service modify the computations of the potential loss for excess, obsolete, and unserviceable inventory and the value of inventory at latest acquisition cost adjustment to comply with DoD 7000.14-R.

OUSD(C) RESPONSE: As an alternative action, the Department proposes to concentrate on evaluating what policy and systems changes would be required to implement and support a latest acquisition valuation method and a direct historical cost valuation method.

RECOMMENDATION B.1.: The Office of the Inspector General, Department of Defense (OIG, DoD) recommended that the Under Secretary of Defense (Comptroller) (USD(C)) develop supplemental guidance on revenue recognition for depot-level reparable exchange price sales. The guidance should prescribe recognition of non-cash revenue equal to the carcass value of unserviceable assets returned as part of the exchange transaction. This change will result in all revenue being recognized at standard price. The guidance should also direct the related changes in the design of the Cost of Goods Sold model for the Navy Working Capital Fund.

OUSD(C) RESPONSE: As an alternative action, the Department proposes to concentrate on evaluating what policy and systems changes would be required to implement and support a latest acquisition valuation method and a direct historical cost valuation method.

Department of the Navy Comments

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON, D.C. 20350-1000

7540
FMO

JUN 20 2000

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Subj: DRAFT AUDIT REPORT ON REVALUATION OF INVENTORY FOR THE FY 1999 DEPARTMENT OF THE NAVY WORKING CAPITAL FUND FINANCIAL STATEMENTS (PROJECT NO. D2000FC-0045.002)

Ref: (a) DODIG memo of 27 Apr 00

Encl: (1) DON Comments on DODIG Draft Audit Report

By reference (a), you requested comments regarding the subject draft report. Comments are provided in enclosure (1).

The point of contact is Mr. Ed Johnson at (202) 685-6703.

C. C. Tisone
A. A. TISONE
Director
Office of Financial Operations

Copy to:
COMNAVSUPSYSCOM

Final Report
Reference

**DEPARTMENT OF THE NAVY COMMENTS
ON
DODIG DRAFT AUDIT REPORT,
"REVALUATION OF INVENTORY FOR THE FY 1999 DEPARTMENT OF THE NAVY
WORKING CAPITAL FUND FINANCIAL STATEMENTS"
(Project No. D2000FC-0045.002)**

Finding A: Defense Finance and Accounting Service Cost of Goods Sold Model.

Recommendation for Corrective Action

A.4. We recommend the Commander, Naval Supply Systems Command (NAVSUPSYSCOM), and the Director, Defense Finance and Accounting Service (DFAS) establish procedures for NAVSUPSYSCOM to provide DFAS with the additional information needed for accurate disclosure of inventory held in reserve for future sale.

Department of the Navy Comment

Concur. In response to Recommendation 13 of Naval Audit Service Audit Report N2000-0014, "Department of the Navy Working Capital Fund Inventory Records and Valuation," dated 30 December 1999, NAVSUPSYSCOM and DFAS Cleveland Center established control procedures to direct all requests for Navy Working Capital Fund financial statement-related data to NAVSUPSYSCOM, Code 132D. This single point of contact, together with the other actions detailed in our response to recommendation C.4, below, will ensure the accurate disclosure of inventory held in reserve for future sale. Action considered complete.

Finding B: Revenue Recognition and Realization of Holding Gains and Losses.

Recommendation for Corrective Action

Revised

B.2. We recommend NAVSUPSYSCOM and DFAS recalculate the ending balance of the allowance for holding gains and losses based on the revised guidance for revenue recognition and realization of holding gains and losses.

Department of the Navy Comment

Concur in principle. We agree the ending balance of the allowance for holding gains and losses should be recalculated to accurately reflect revenue recognition for depot-level reparable exchange price sales. However, recalculation is the responsibility of DFAS Cleveland Center and cannot be accomplished until the Under Secretary of Defense (Comptroller) (USD(C)) issues supplemental guidance (recommendation B.1.) on revenue recognition for depot-level reparable exchange price sales. We request the recommendation be written as follows: "We recommend the Director, DFAS, with support from NAVSUPSYSCOM

Enclosure (1)

as required, recalculate the ending balance of the allowance for holding gains and losses based on the USD(C) supplemental guidance for revenue recognition and realization of holding gains and losses."

Finding C: Calculations Affecting the Presentation and Disclosure of Inventory.

Recommendation for Corrective Action

C.1. We recommend the Commander, NAVSUPSYSCOM, modify the NAVSUPSYSCOM revaluation spreadsheets to calculate the estimated cost to repair unserviceable inventory using a ratio based on total unserviceable inventory.

Department of the Navy Comment

Concur. The NAVSUPSYSCOM revaluation spreadsheets have been modified to calculate the estimated cost to repair unserviceable inventory using a ratio based on total unserviceable inventory. Action considered complete.

Recommendation for Corrective Action

C.2. We recommend the Commander, NAVSUPSYSCOM, modify the NAVSUPSYSCOM revaluation spreadsheets to include the estimated cost to repair unserviceable in-transit inventory in the adjustment to record the estimated cost to repair unserviceable inventory instead of in the latest acquisition cost adjustment.

Department of the Navy Comment

Concur. The NAVSUPSYSCOM revaluation spreadsheets have been modified as recommended and have been used for the May 2000 inventory revaluation. Action considered complete.

Recommendation for Corrective Action

C.3. We recommend the Commander, NAVSUPSYSCOM, modify the NAVSUPSYSCOM revaluation spreadsheets to establish controls to detect clerical errors during the manual entry of data in the spreadsheets.

Department of the Navy Comment

Concur. Although it is not possible to totally eliminate clerical errors, the spreadsheets have been modified to provide check totals and link as much data as possible. Additionally, data input is verified against the source documentation prior to making the journal entries. Action considered complete.

Recommendation for Corrective Action

C.4. We recommend the Commander, NAVSUPSYSCOM, modify the NAVSUPSYSCOM revaluation spreadsheets to calculate the value of war reserve material for footnote disclosure to include all inventory retained for Military Contingency.

Department of the Navy Comment

Concur. The NAVSUPSYSCOM spreadsheets have been changed to calculate War Reserves using all four categories of inventory retained for military contingencies. This information will be used to provide data for Note 8.A of the FY 2000 Department of the Navy Working Capital Fund financial statements. Action considered complete.

3

Defense Finance and Accounting Service Comments

DEFENSE FINANCE AND ACCOUNTING SERVICE
1931 JEFFERSON DAVIS HIGHWAY
ARLINGTON, VA 22240-5291
WWW.DFAS.MIL

DFAS-HQ/ASF

JUL 18 2000

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

SUBJECT: Audit Report on Revaluation of Inventory for the FY 1999 Department of the Working Capital Fund Financial Statements (Project No. D2000FC-0045.002)

Our response to the subject audit is attached. The primary point of contact (POC) is Mr. Wayne Ebaugh, (703) 607-2857 or DSN 327-2857, and the secondary POC is Mr. Adam Ochlis, (703) 607-5118 or DSN 327-5118.

Edward A. Harris
Director for Accounting

Attachment:
As stated

cc:
DFAS-HQ/DI
DFAS-CL/PI
OUSD(C)

DFAS Comments on DoDIG Audit Report on Revaluation of Inventory for the FY 1999 Department of the Navy Working Capital Fund Financial Statements (Project No. D2000FC-0045.002)

__Responses to Recommendations__

Recommendation A1. We recommend that the Under Secretary of Defense (Comptroller) and Director, Defense Finance and Accounting Service modify the computations of the potential loss for excess, obsolete, and unserviceable inventory and the value of inventory at latest acquisition cost adjustment to comply with DoD 7000.14-R.

DFAS Management Comments: The Defense Finance and Accounting Service (DFAS) agrees with the intent and theory of this recommendation; however, this is primarily an issue for the Accounting Policy Directorate of the Office of the Deputy Chief Financial Officer (ODCFO(AP)). The ODCFO(AP) is responsible for providing adequate documentation and guidance for the spreadsheet model to ensure that it is consistent with DoD 7000.14-R, including guidance for valuing Excess, Obsolete, and Unserviceable Inventory.

Recommendation A.2A. We recommend that the Director, Defense Finance and Accounting Service modify operational procedures for executing the Cost of Goods Sold model to accurately restate inventory at standard price at the beginning of the Fiscal Year.

DFAS Management Comments: DFAS defers this recommendation to the ODCFO(AP). The DFAS will implement the model as directed. The Supply Management Business Area has drafted basic instructions for entering data into the spreadsheet model. Official detailed documentation and instructions on the use of the model and authorization to change the operation of the model must come from the ODCFO(AP).

Recommendation A.2B. We recommend that the Director, Defense Finance and Accounting Service modify operational procedures for executing the Cost of Goods Sold model to classify economic retention stock, contingency retention stock, and war reserve material as Inventory Held for Future Sale.

DFAS Management Comments: Concur. The DFAS Cleveland Center (DFAS-CL), with concurrence from the NAVSUP, will classify economic retention stock, contingency retention stock, and war reserve material as Inventory Held for Future Sale. This action will require NAVSUP to provide DFAS-CL with additional information, specifically, the values of economic retention stock, contingency retention stock, and war reserve material.

Estimated Completion Date: September 2000.

Recommendation A.2C. We recommend that the Director, Defense Finance and Accounting Service modify operational procedures for executing the Cost of Goods Sold model to classify "G condition" material as Inventory Held for Repair.

DFAS Management Comments: Concur. DFAS-CL, with concurrence from the Naval Supply Systems Command (NAVSUP), the Under Secretary of Defense (Comptroller) and DFAS-HQ, will classify "G condition" material as Inventory Held for Repair.

Estimated Completion Date: September 2000.

Recommendation A.2D. We recommend that the Director, Defense Finance and Accounting Service modify operational procedures for executing the Cost of Goods Sold model to accurately allocate the journal entries to recognize the potential loss on excess, obsolete, and unserviceable inventory and to reduce inventory from standard price to latest acquisition cost between acquisition cost between the inventory categories.

DFAS Management Comments: DFAS defers this recommendation to the ODCFO(AP). The DFAS will implement the model as directed. The Supply Management Business Area has drafted basic instructions for entering data into the spreadsheet model. Official detailed documentation and instructions on the use of the model and authorization to change the operation of the model must come from the ODCFO(AP).

Recommendation A.3. We recommend that the Director, Defense Finance and Accounting Service calculate and record the prior period adjustment to restate inventory at the end of FY 1999. The adjustment is needed to correct misstatements that have occurred since FY 1995 because of erroneous calculations and to eliminate imbalances between the Cost of Goods Sold model and the Central Data Base identified in Table 1 and Table 2.

DFAS Management Comments: DFAS defers this recommendation to the ODCFO(AP). The DFAS will implement the model as directed. The Supply Management Business Area has drafted basic instructions for entering data into the spreadsheet model. Official detailed documentation and instructions on the use of the model and authorization to change the operation of the model must come from the ODCFO(AP).

Recommendation A.4. We recommend that the Commander, Naval Supply Systems Command, and the Director, Defense Finance and Accounting Service establish procedures for the Naval Supply Systems Command to provide the Defense Finance and Accounting Service with the additional information needed for accurate disclosure of inventory held in reserve for future sale.

DFAS Management Comments: Concur. DFAS-CL and NAVSUP will work together to establish procedures to ensure that the Naval Supply Systems Command provides DFAS-CL with the additional information needed for the accurate reporting of Inventory Held in Reserve for Future Sale. This action will require NAVSUP to provide DFAS-CL/AA with additional information, specifically, the values of economic retention stock, contingency retention stock, and war reserve material.

Estimated Completion Date: September 2000.

Final Report
Reference

Revised

Recommendation B.2. We recommend that the Naval Supply Systems Command and the Defense Finance and Accounting Service recalculate the ending balance of the allowance recognition and realization of holding gains and losses.

DFAS Management Comments: DFAS defers this recommendation to the ODCFO(AP). The DFAS will implement the model as directed. The Supply Management Business Area has drafted basic instructions for entering data into the spreadsheet model. Official detailed documentation and instructions for the spreadsheet model that address the computation of revenue recognition for depot-level reparable exchange price sales must come from the ODCFO(AP).

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report.

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