

**A** *udit*



**R** *eport*

USE OF CONTRACT AUTHORITY FOR DISTRIBUTION DEPOTS  
BY THE DEFENSE LOGISTICS AGENCY

Report No. D-2001-099

April 16, 2001

Office of the Inspector General  
Department of Defense

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### **Acronyms**

DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DWCF	Defense Working Capital Fund
OMB	Office of Management and Budget
USD (Comptroller)	Under Secretary of Defense (Comptroller)



INSPECTOR GENERAL  
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April 16, 2001

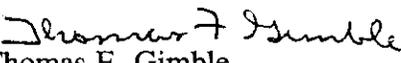
MEMORANDUM FOR UNDER SECRETARY OF DEFENSE  
(COMPTROLLER/CHIEF FINANCIAL OFFICER)

SUBJECT: Audit Report on the Use of Contract Authority for Distribution Depots by  
the Defense Logistics Agency (Report No. D2001-099)

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

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

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. James L. Kornides at (614) 751-1400, extension 11, (jkornides@dodig.osd.mil) or Mr. Stuart D. Dunnett at (614) 751-1400, extension 14, (sdunnett@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

  
Thomas F. Gimble  
Acting  
Deputy Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

Report No. D-2001-099

(Project No. D2000FJ-0071.01)

April 16, 2001

### Use of Contract Authority for Distribution Depots by the Defense Logistics Agency

#### Executive Summary

**Introduction.** Contract authority is a form of budget authority granted by specific statutory authority to incur obligations in anticipation of either receipts or an appropriation of liquidating cash with which to pay the obligations. Because it is used in advance of appropriations or other funding, it is different from the inherent authority normally granted to every Government agency, that is, to enter into contracts or obligations based on available funds. Agencies using contract authority must receive appropriations or obtain receipts or collections sufficient to liquidate obligations.

The Under Secretary of Defense (Comptroller) is responsible for allocating contract authority to the activity groups of the Defense working capital fund. The contract authority is automatically liquidated when reimbursements are reported to the Office of Management and Budget. Since FY 1992, the Under Secretary of Defense (Comptroller) has authorized the Defense Logistics Agency (DLA), a part of the Defense working capital fund, to use contract authority to operate certain business activities, including its distribution depot activity group, which receives, stores, and issues stocks of inventory. From FY 1992 through FY 2000, DLA used \$12.2 billion of contract authority of which \$1.8 billion was used by the distribution depots.

**Objectives.** The objective of the audit was to determine whether the Defense Finance and Accounting Service Columbus consistently and accurately compiled financial data from field activities and other sources for the financial statements of the DLA. This part of the audit determined whether the contract authority DLA used for its business activity groups was properly posted to the accounting records. Additionally, we determined whether the contract authority was recorded on the distribution depot accounting records and whether DLA established distribution depot billing rates sufficient to liquidate the contract authority allocated to the DLA distribution depot activity group.

**Results.** From FY 1992 through FY 2000, DLA used \$1.8 billion of contract authority to fund the operations of the DLA distribution depot activity group. However, accounting information documenting the use of the authority was not posted to the accounting records of the distribution depot activity group. Additionally, the distribution depot activity group did not collect enough revenue to cover \$1.1 billion of its prior year disbursements. To offset the shortfall in revenue, the Under Secretary of

Defense (Comptroller) used funds collected by the DLA supply management activity group to liquidate \$1.1 billion in outstanding contract authority that was provided to the distribution depot activity group. Because the cash deficits at the distribution depots were eliminated by using cash from the supply management activity group, the occurrence of deficits was not reflected on financial statements or budget estimates and did not require management to make further adjustments, including cutting costs or raising rates at the distribution depots. Additionally, operating results for the distribution depot and supply management activity groups were distorted.

The audit identified a material management control weakness. Implementing the recommendations will ensure that the Under Secretary of Defense (Comptroller) establishes controls over the accounting and reimbursement of contract authority. See the Finding section for the audit results and Appendix A for a discussion of our review of the management control program.

**Summary of Recommendations.** We recommend that the Under Secretary of Defense (Comptroller) modify DoD Financial Management Regulations to ensure that contract authority is recorded and liquidated at the activity group level. We also recommend that during the next budget review, the Under Secretary of Defense (Comptroller) consider the actual cash position of the distribution depot activity group and make appropriate cash transfers or billing rate adjustments.

**Management Comments.** The Director of DoD Revolving Funds concurred and stated that he will review and modify the DoD Financial Management Regulation and make any required changes to ensure that the policy on the use of contract authority is clear and that the procedures are specified. He also concurred with the recommendation to consider the actual cash position of the Distribution Depot activity group and make appropriate cash transfers or billing rate adjustments during the next budget cycle. A discussion of management comments is in the Finding section of the report and the complete text in the Management Comments section.

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## Background

Before FY 1991, the Military Departments and the Defense Logistics Agency (DLA) operated their own distribution depots using direct Operation and Maintenance appropriations. In FY 1992, the Under Secretary of Defense (USD) (Comptroller), consolidated most distribution depot operations under the DLA distribution depot activity group.

The DLA distribution depot activity group is currently a part of the Defense working capital fund (DWCF). The distribution depots operate primarily on reimbursements earned from the Military Departments and DLA supply management activity groups for materiel received and shipped, storage space occupied, and reimbursable funding provided by inventory managers or local organizations for special project work. Inventory control points include these costs in surcharges applied to sales of materiel they manage. These rates are developed and submitted as part of an agency's budget formulation process and are to be established at levels sufficient to recover the costs of products or services. During FY 2000 the distribution depots collected \$1.5 billion in revenue for warehousing services.

The Defense Finance and Accounting Service (DFAS) Columbus provides accounting support for the DLA distribution depot activity group. DLA is responsible for budget formulation, presentation, and execution for five DLA activity groups: supply management, distribution depots, Defense Reutilization and Marketing Service, and Defense Automated Printing Service.

Contract authority is a form of budget authority granted by Congress that permits contracts or other obligations to be entered into in advance of an appropriation or in excess of amounts otherwise available in a working capital fund. Contract authority is distinguished from the inherent authority to enter into contracts possessed by every Government agency based on the availability of funds. The USD (Comptroller) is responsible for allocating stock fund contract authority to the activity groups of the Defense working capital fund. The contract authority is automatically liquidated at the summary Defense working capital fund level. Since FY 1992, the USD (Comptroller) has authorized the DLA to use contract authority to operate certain business activities, including its distribution depot activity group, which receives, stores, and issues stocks of inventory.

## Objectives

The objective of the audit was to determine whether DFAS Columbus consistently and accurately compiled financial data from field activities and other sources for the financial statements of the DLA. This part of the audit determined whether the contract authority DLA used for its business activity groups was properly compiled and posted to the accounting records.

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Additionally, we determined whether the contract authority was recorded on the distribution depot accounting records and whether DLA established distribution depot billing rates sufficient to liquidate the contract authority allocated to the DLA distribution depot activity group.

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## Controls Over Defense Logistics Agency Stock Fund Contract Authority

From FY 1992 through FY 2000, DLA used \$1.8 billion of contract authority to fund the operations of the DLA distribution depot activity group. However, accounting information documenting the use of the authority was not posted to the accounting records of the distribution depot activity group. Additionally, the distribution depot activity group did not collect enough revenue to cover \$1.1 billion of prior year disbursements. To offset the shortfall in revenue, the USD (Comptroller) used funds collected by the DLA supply management activity group to liquidate \$1.1 billion in contract authority that was provided to the distribution depot activity group. The action by the USD (Comptroller) was taken because procedures had not been established to account for use of contract authority at the activity group level and billing rates for the distribution depots did not cover operating costs. Because the cash deficits at the distribution depots were eliminated using cash from the supply management activity group, the occurrence of deficits was not reflected on financial statements or in budget estimates and did not require management to make further adjustments, including cutting costs or raising rates at the distribution depots. Additionally, operating results for the distribution depot and supply management activity groups were distorted.

### Legal and Regulatory Guidance

Section 2210(b), title 10, United States Code (U.S.C.) provides a statutory basis for DoD to use unfunded contract authority to operate stock funds. Specifically, the law allows DoD to incur obligations against anticipated reimbursements to stock funds in such amounts and for such periods as the Secretary of Defense, with the approval of the President, may determine to be necessary to maintain stock levels consistent with planned operations for the fiscal year.

**Office of Management and Budget Guidance.** Office of Management and Budget (OMB) Circular A-34, 1999, provides instructions and guidance to agencies concerning apportionment and budget execution requirements. The Circular defines contract authority as specific statutory authority to incur obligations in anticipation of either receipts or an appropriation of liquidating cash with which to pay the obligations. The Circular also requires agencies to report contract authority on the Standard Form 132 “Apportionment and Reapportionment Schedule,” and Standard Form 133 “Report on Budget Execution.”

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OMB apportions contract authority based upon SF 132 schedules submitted by the USD (Comptroller) for the Defense working capital fund. The SF 132 schedules require the apportioned contract authority to be automatically reduced when liquidating collections are made. DFAS Columbus compiles contract authority and liquidating collections to SF 133 reports for each DLA activity group.

**DoD Policy.** DoD Regulation 7000.14-R, the “DoD Financial Management Regulation,” volume 3, “Budget Execution - Availability and Use of Budgetary Resources,” September 2000, defines the distribution depot activity group as a supply-type operation that can be provided contract authority (the definition was included in the December 1996 version of the Regulation). Volume 3 authorizes supply-type activity groups to use stock fund contract authority as a basis for operating authority. The Regulation states that the USD (Comptroller) Revolving Funds Directorate will review budget execution on a monthly basis.

## **Use of Contract Authority by Distribution Depots**

Most revenue for the distribution depot activity group consists of payments from customers for items received and shipped, storage space occupied, and reimbursable funding provided by inventory managers or local activities for special project work. Inventory control points include these costs in surcharges applied to sales of materiel they manage. These rates are developed and submitted as part of the agency’s budget formulation process and are to be established at levels sufficient to recover the costs of products or services.

The DLA distribution depots used contract authority with the expectation that the depot activity group would reimburse the authority with revenue it earned through its working capital fund. The Defense Logistics Agency’s distribution depot activity group used contract authority five times since FY 1992, when it began operating as a working capital fund.

Approximately \$1.8 billion of contract authority was used over the 6 years from FY 1992 to FY 1997. However, the distribution depot activity group was able to reimburse only approximately \$679 million with surplus collections earned during FYs 1993, 1999, and 2000. The amounts provided were displayed in budget reports, specifically SF 133s.

Table 1 shows the contract authority provided to the DLA distribution depots and the amounts the depots reimbursed.

<b>Table 1. Stock Fund Contract Authority for the Distribution Depot Activity Group</b>		
<u>FY</u>	<u>Contract Authority Provided</u>	<u>Contract Authority Reimbursed With Depot Collections<sup>1</sup></u>
1992	\$ 516,921,391	\$ 0
1993	0	346,835,337
1994	77,753,918	0
1995	247,611,660	0
1996	485,441,893	0
1997	451,948,567	0
1998	0	0
1999	0	243,408,301
2000	0	88,918,755
<b>Total</b>	<b>\$1,779,677,429</b>	<b>\$679,162,393</b>

<sup>1</sup> These are the amounts of the cash surpluses reported on SF 133 reports for FYs 1993, 1999, and 2000. Cash deficits were incurred in the other years (see Table 2).

## Recording Use of Contract Authority

DoD Regulation 7000.14-R, the “DoD Financial Management Regulation,” volume 11B, “Reimbursable Operations, Policy and Procedures - Defense Business Operations Fund,” December 1994, provides guidance on the use of stock fund contract authority by the supply management activity groups of the Defense working capital fund. The Regulation provides accounting entries at the DWCF level related to anticipated, realized, and liquidated contract authority transactions.

DFAS Columbus did not post entries for the \$1.8 billion of the stock fund contract authority that it reported on the distribution depot budget execution reports (SF 133s) from FY 1992 through FY 2000. DFAS Columbus was following OMB guidance and compiling contract authority and liquidating collections in SF 133 reports for each DLA activity group, but it was not recording the use or reimbursement of the authority in the accounting records.

When we asked DFAS Columbus to provide accounting entries regarding the use and liquidation of the \$1.8 billion in contract authority, DFAS Columbus personnel told us that the journal entries were not recorded because contract authority was approved and automatically liquidated at the DWCF level.

We reviewed DoD Regulation 7000.14, volume 11B, and confirmed that it does not require accounting entries to be made on activity group records for DWCF stock fund contract authority. As a result of this policy, no accounting entries were recorded for any of the contract authority provided to the DLA distribution depots.

We believe that the accounting policy needs to require accountability records to be maintained at the activity group level. If adequate accounting procedures had been in place, the shortages in revenue of the distribution depots would have been clearly evident to senior DoD management during budget deliberations and on DLA financial statements. Additionally, the distribution depots' difficulty with earning enough revenue to liquidate the contract authority used may have caused management to focus on changes needed in the DLA business strategies.

## Reimbursement of Contract Authority Used

The distribution depots did not earn enough revenue from providing warehouse services to liquidate \$1.1 billion of the \$1.8 billion in contract authority. Specifically, the distribution depots raised rates high enough to reimburse only \$679.2 million of \$1.8 billion in contract authority first used in FY 1992. DFAS records showed that the USD (Comptroller) used funds collected by the DLA supply management activity group to liquidate the remaining \$1.1 billion in contract authority. However, the \$1.1 billion transfer of funds was never recorded on activity group accounting records.

The distribution depot activity group used the \$1.8 billion in stock fund contract authority to continue operating even though the activity group accumulated a cash deficit for FYs 1992 through 2000. According to SF 133 reports, the distribution depot cash deficit totaled \$1.1 billion during the 9 years that the activity group operated as part of a working capital fund (see Table 2).

<u>FY</u>	<u>Collections</u>	<u>Disbursements</u>	<u>Reported Surplus or Deficit</u>
1992	\$ 95,063,357	\$ 862,039,633	\$ (766,976,276)
1993	1,495,176,844	1,148,341,506	346,835,338
1994	1,330,429,117	1,563,204,328	(232,775,211)
1995	1,266,313,073	1,594,191,876	(327,878,803)
1996	1,708,003,496	1,715,448,165	(7,444,669)
1997	1,279,364,415	1,567,967,443	(288,603,028)
1998	1,266,791,086	1,451,265,487	(184,474,401)
1999	1,517,837,825	1,274,429,524	243,408,301
2000	1,541,059,662	1,452,140,907	88,918,755
<b>Total</b>	<b>\$11,500,038,875</b>	<b>\$12,629,028,869</b>	<b>\$(1,128,989,994)</b>

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**Reimbursable Rates.** DoD Regulation 7000.14-R, the “DoD Financial Management Regulation,” volume 2B, “Budget Formulation and Presentation,” June 2000, establishes two categories of activity groups for rate setting purposes: “supply management” activity groups, and “non-supply management” activity groups. Volume 2B categorizes distribution depots as a non-supply management activity group. DoD Regulation 7000.14-R requires both activity groups to set prices to either make up actual or projected losses or to return actual or projected gains in the budget year(s). DoD Regulation 7000.14-R requires the supply management activity group to include in its surcharge the costs of reimbursing the distribution depots for their operating costs.

DLA activity groups recover their costs through reimbursable customer orders. Cost recovery rates are developed jointly by the USD (Comptroller) and DLA and approved by the Deputy Secretary of Defense. Budget documents showed that distribution depot rates were raised for FYs 1998 and 1999. However, distribution depot rates were not raised sufficiently to eliminate the \$1.1 billion cash deficit as required by DoD regulations.

DFAS records indicate that the outstanding \$1.1 billion of contract authority used by the distribution depots was liquidated by the USD (Comptroller) at the DWCF-level using reimbursements earned by the DLA supply management activity group. However, DLA personnel stated that DLA did not authorize the transfer of the funds from the DLA supply management activity group to the distribution depot activity group and, therefore, a \$1.1 billion cash deficit remained recorded on distribution depot accounting records.

During the next budget cycle, the USD (Comptroller) should either officially authorize \$1.1 billion in prior-year transfers to the distribution depot activity group from the supply management activity group or adjust billing rates.

## Summary

From FY 1992 to FY 2000, the DLA distribution depot activity group did not collect enough revenue to cover \$1.1 billion of its disbursements. This occurred because the billing rates that were established to cover distribution depot costs proved to be inadequate and were not sufficiently adjusted during budget reviews. The distribution depot activity group continued to operate using contract authority while accumulating large cash deficits, and funds from the supply management activity group were used to liquidate the distribution depots’ contract authority. The accounting transactions for these transfers of cash were not posted to the accounting records, and rates for the depots were not raised for the amounts of the transfers. USD (Comptroller) personnel believed that management and accounting for all activity groups at the summary level was all that was needed. We believe this level of management and accounting was not adequate. The distribution depot activity group was established as a stand-alone entity. All accounting events that affect it should be posted and adequate fees should be charged to customers to make it a viable business concern. Without

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those types of changes, the distribution depot activity group will not meet the principal goal established for a working capital fund activity group, which is to operate efficiently enough to break even over the long term.

## **Recommendations, Management Comments, and Audit Response**

### **1. We recommend that the Under Secretary of Defense (Comptroller):**

**a. Modify DoD Regulation 7000.14-R, the “DoD Financial Management Regulation,” volume 11B, “Reimbursable Operations, Policy and Procedures – Defense Business Operations Fund,” December 1994, to include procedures that require that all use of contract authority is adequately posted and liquidated in the DoD working capital fund accounting records at the activity group level.**

**Management Comments.** The Director of DoD Revolving Funds concurred stating that he will review and modify the DoD Financial Management Regulation and make any required changes to ensure the policy on the use of contract authority is clear and procedures are specified.

**b. Consider the actual cash position of the distribution depot activity group and make appropriate cash transfers or billing rate adjustments during the next budget cycle.**

**Management Comments.** The Director of DoD Revolving Funds concurred.

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# Appendix A. Audit Process

## Scope and Methodology

**Work Performed.** This audit resulted from tests of compliance with laws and regulations on Project No. D2000FJ-0071, “Audit of the Compilation of DLA FY 1999 Financial Statements.”

We determined whether distribution depot contract authority was liquidated in accordance with applicable laws and regulations. We also reviewed the adequacy of internal controls over \$1.1 billion in DLA contract authority. Specifically, we determined whether DLA and the DFAS Columbus authorized, posted, and documented contract authority provided to the DLA distribution depot activity group. We reviewed SF 132 schedules and SF 133 reports as available from FY 1992 through FY 2000. Specifically, we completed an analysis of \$11.5 billion in distribution depot collections and \$12.6 billion in distribution depot disbursements.

**Use of Computer-Processed Data.** We analyzed DLA budget execution reports for FYs 1992 through 2000. We analyzed the data to determine the amount of contract authority that was reported for the DLA distribution depot activity group and to determine the amounts that had been liquidated.

**DoD-Wide Corporate-Level Government Performance and Results Act Coverage.** 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 corporate-level goal, subordinate performance goals, 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 2.3:** Streamline the DoD infrastructure by redesigning the Department’s support structure and pursuing business practice reforms **(01-DoD-2.3)**.
- **FY 2001 Subordinate Performance Goal 2.5:** Improve financial and information management. **(01-DoD-2.5)**
- **FY 2001 Performance Measure 2.3.8:** Use net operating results to ensure that Defense working capital funds break even over the long term. **(01-DoD-2.3.8.)**

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

**General Accounting Office High-Risk Area.** The General Accounting Office had identified several high-risk areas in the DoD. This report provides coverage of the financial management high-risk area.

**Audit Type, Dates, and Standards.** We performed this financial-related audit from May 2000 through January 2001 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We included tests of management controls considered necessary.

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

## Management Control Program Review

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

**Scope of the Review of the Management Control Program.** We reviewed DLA and DFAS management controls over the stock fund contract authority that was used by the distribution depot activity group since FY 1992.

**Adequacy of Management Controls.** We identified materiel management control weaknesses for DoD, as defined by DoD Instruction 5010.40. DoD management controls were not adequate to ensure that distribution depot activity group contract authority transactions were posted to the accounting records. This occurred because the USD (Comptroller) did not issue procedures to require accountability at the activity group level. The recommendations, if implemented, will allow the USD (Comptroller) to improve visibility and control of contract authority.

**Adequacy of Management's Self-Evaluation.** Management's self-evaluation would not identify controls over contract authority and make them an assessable unit because the USD (Comptroller) had not issued procedures. Therefore, DLA and DFAS Columbus did not report the material management control weaknesses identified during the audit.

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## 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>.

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## **Appendix B. Report Distribution**

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

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

### **Other Defense Organizations**

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

### **Non-Defense Federal Organizations**

Office of Management and Budget

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

Senate Committee on Appropriations  
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House Subcommittee on Technology and Procurement Policy, Committee on Government Reform



# Under Secretary of Defense (Comptroller) Comments



(Program/Budget)

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

MAR 30 2001

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Draft Audit Report on the Use of Contract Authority for Distribution Depots by  
the Defense Logistics Agency (Project No. D2000FJ-0071.01)

In your draft audit dated January 31, 2001, you recommended that the Under Secretary of  
Defense (Comptroller):

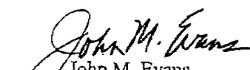
(a) Modify the DoD Financial Management Regulation (FMR) Volume 11B to include  
procedures that require that all use of contract authority is adequately posted and  
liquidated in the Defense Working Capital Fund accounting records at the activity  
group level.

(b) Consider the actual cash position of the distribution depot activity group and make  
appropriate cash transfers or billing rate adjustments during the next budget cycle.

This office concurs with the recommendations with comment, provided below.

Recommendation (a). This office will review and modify the FMR and make any  
required changes necessary to ensure the policy on the use of contract authority is clear  
and the procedures specified.

Recommendation (b). Concur.

  
John M. Evans  
Director for Revolving Funds

## **Audit Team Members**

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

F. Jay Lane

Salvatore D. Guli

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