

# Inspector General

United States  
Department of Defense



DOD Methodology for the Valuation of Excess,  
Obsolete, and Unserviceable Inventory  
and Operating Materials and Supplies

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## Acronyms and Abbreviations

DLA	Defense Logistics Agency
DRMS	Defense Reutilization and Marketing Service
EOU	Excess, Obsolete, and Unserviceable
FMR	Financial Management Regulation
OM&S	Operating Materials and Supplies
SFFAS	Statement of Federal Financial Accounting Standards



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

March 25, 2010

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE  
(COMPTROLLER)/CHIEF FINANCIAL OFFICER  
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: DOD Methodology for the Valuation of Excess, Obsolete, and Unserviceable  
Inventory and Operating Materials and Supplies (Report No. D-2010-048)

We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report.

DOD Directive 7650.3 requires that recommendations be resolved promptly. The Defense Logistics Agency comments on Recommendations A.1, A.2, and A.3 were not responsive. Therefore, we request additional comments from the Defense Logistics Agency on Recommendations A.1, A.2, and A.3 by April 26, 2010.

If possible, send a .pdf file containing your comments to [audcolu@dodig.mil](mailto:audcolu@dodig.mil). Copies of your comments must have the actual signature of the authorizing official for your organization. We are unable to accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, you must send them over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5868 (DSN 329-5868).

*Patricia A. Marsh*  
Patricia A. Marsh, CPA  
Assistant Inspector General  
Defense Business Operations





# Results in Brief: DOD Methodology for the Valuation of Excess, Obsolete, and Unserviceable Inventory and Operating Materials and Supplies

## What We Did

The Under Secretary of Defense (Comptroller)/Chief Financial Officer requested us to evaluate the reasonableness of the DOD methodology for valuing excess, obsolete, and unserviceable inventory and operating materials and supplies. DOD based its methodology on a methodology that the Defense Logistics Agency (DLA) developed to value its excess, obsolete, and unserviceable inventory. We evaluated the DLA methodology and its applicability throughout the DOD Military Departments.

## What We Found

The DLA methodology for estimating the net realizable value for its FY 2008 \$5.8 billion excess, obsolete, and unserviceable inventory is a good starting point. However, the methodology does not produce a reasonable estimate in accordance with generally accepted accounting principles.

The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer revised the DOD Financial Management Regulation to require the Military Departments to use the DLA net realizable value methodology before assessing whether it would result in a reasonable estimate. The composition of the \$5.8 billion in DLA excess, obsolete, and unserviceable inventory is not representative of the composition of the \$5.2 billion in Military Departments' excess, obsolete, and unserviceable inventory and operating materials and supplies.

Without corrective action on the internal control weakness identified in the report, future estimates of DoD excess, obsolete, and unserviceable inventory and operating materials and supplies will be misstated.

## What We Recommend

The Director, DLA, should modify the existing DLA net realizable value methodology.

The Under Secretary of Defense (Comptroller)/Chief Financial Officer should suspend implementation of the provisions in the DOD Financial Management Regulation, volume 4, chapter 4, for valuing excess, obsolete, and unserviceable inventory and operating materials and supplies held by the Military Departments and coordinate with the Military Departments and the U.S. Army Joint Munitions Command to develop methodologies to value excess, obsolete, and unserviceable inventory and operating materials and supplies, including munitions and tactical missiles.

## Management Comments and Our Response

The Director, DLA, disagreed with the recommendations and provided nonresponsive comments. We request that the Director reconsider his position and provide additional comments. The Under Secretary of Defense (Comptroller)/Chief Financial Officer agreed with the recommendations and provided fully responsive comments. The full text of all comments appears in the Management Comments sections of the report. Please see the recommendations table on the back of this page.

## Recommendations Table

Management	Recommendations Requiring Comment	No Additional Comments Required
Under Secretary of Defense (Comptroller)/Chief Financial Officer		B.1, B.2
Director, Defense Logistics Agency	A.1, A.2, A.3	

**Please provide comments by April 26, 2010.**

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# Introduction

## Objectives

We performed this audit at the request of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. Our objective was to evaluate the reasonableness of the DOD methodology for valuing excess, obsolete, and unserviceable (EOU) inventory and operating materials and supplies (OM&S).<sup>1</sup> Specifically, we determined whether the methodology and assumptions provided a reasonable estimate of the net realizable value for financial reporting and were in accordance with generally accepted accounting principles. See Appendix A for a discussion of the scope and methodology, and for prior coverage related to the objective.

## Background

### ***Defense Reutilization and Marketing Service***

Military Departments and Defense agencies turn in excess<sup>±</sup> property to the Defense Reutilization and Marketing Service (DRMS). DRMS is a DLA organization that manages DOD's surplus property program by disposing of the excess DOD property. DRMS first offers property to DOD organizations for reutilization. If DOD organizations do not reutilize the excess property, DRMS offers it for transfer or donation to other Federal agencies, state or local governments, or other qualified organizations. DRMS also offers the excess property for sale<sup>±</sup> or grant<sup>±</sup> to other countries through its foreign military sales program. For useable items that DRMS does not dispose of by these means, DRMS turns them over to a contractor for public sale at a contracted rate of return. The most recent DRMS contract for sale of usable items requires the contractor to pay 1.8 percent of the item's acquisition value.<sup>±</sup> In FY 2008, more than 56,000 military units turned in over 3.5 million items to DRMS.

### ***Defense Logistics Agency Inventory***

DLA is DOD's largest logistics combat support agency. DLA supplies the Military Departments with consumable items and repair parts, and it helps them to dispose of unneeded materiel and equipment. DLA maintains inventory through its inventory control points.<sup>±</sup> DLA eventually disposes of excess,<sup>±</sup> obsolete,<sup>±</sup> and unserviceable<sup>±</sup> (EOU) inventory<sup>±</sup> through DRMS. At the end of a financial reporting period, DLA inventory control points report on-hand EOU inventory that they have not turned in to DRMS. DLA managed approximately \$5.8 billion of the \$11.3 billion DOD excess, obsolete, and unserviceable inventory and OM&S as of September 30, 2008.

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<sup>1</sup> This audit focused on the valuation of DLA and Military Department EOU inventory and OM&S and did not specifically cover any other Defense agencies or DOD organizations.

<sup>±</sup> Designates a term explained in the glossary.

## ***Military Department Inventory and OM&S***

The Military Departments maintain inventory through their respective inventory control points to support their customers. The Military Departments also report operating materials and supplies<sup>±</sup> (OM&S) that are maintained throughout their respective field units and organizations. The Military Departments eventually dispose of EOU inventory and OM&S through DLA's DRMS. At the end of a financial reporting period, the Military Departments report on-hand EOU inventory and OM&S that they have not turned over to DRMS. The Military Departments managed approximately \$5.2 billion of the \$11.3 billion DOD EOU inventory and OM&S as of September 30, 2008.

## ***Federal Government Inventory Valuation Policy***

The Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," October 27, 1993, provides the inventory valuation policy for Federal agencies. SFFAS No. 3 represents the generally accepted accounting principles for DOD inventory valuation.

SFFAS No. 3 defines inventory as tangible personal property held for sale, in the process of production for sale, or for use in the production of goods for sale or in the provision of services for a fee. Excess inventory exceeds the demand expected in the normal course of operations because the amount on hand is more than can be sold in the near future. Obsolete inventory are items organizations no longer need because of changes in technology, laws, customs, or operations. Unserviceable inventory is damaged stock that is more economical to dispose than to repair.

SFFAS No. 3 defines OM&S as tangible personal property used in normal operations. Excess OM&S exceed the amount expected to be used in normal operations because the amount on hand is more than what can be used in the foreseeable future. Excess OM&S also do not meet management's criteria to hold in reserve for future use. Obsolete OM&S are items organizations no longer need because of changes in technology, laws, customs, or operations. Unserviceable OM&S are items organizations cannot use in operations because of physical damage.

SFFAS No. 3 specifies valuing EOU inventory and OM&S at their expected net realizable value.<sup>±</sup> Net realizable value is the estimated amount organizations can recover from selling or disposing of items reduced by the estimated costs of completing the sale or disposal. The difference between the carrying amount<sup>±</sup> before identification of EOU items and its expected net realizable value is recognized as a loss (or gain) and either separately reported or disclosed.

## **DOD Net Realizable Value Methodology**

In May 2009, the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer updated DOD 7000.14-R, “DOD Financial Management Regulation (FMR),” volume 4, “Accounting Policies and Procedures,” chapter 4, “Inventory and Related Property,” to include details on a methodology for use by all DOD organizations (DLA, Military Departments, and Defense agencies) to estimate the net realizable value of DOD EOU inventories and OM&S (see Appendix B for the details on the DOD methodology). DOD based its methodology on a methodology DLA developed to value its EOU inventory. DLA based its methodology on the composition of inventory that DRMS maintained.

## **Review of Internal Controls**

DOD Instruction 5010.40, “Managers’ Internal Control (MIC) Program Procedures,” January 4, 2006, requires DOD organizations to implement a comprehensive system of internal controls that provides reasonable assurance that programs are operating as intended and to evaluate the effectiveness of the controls. We identified an internal control weakness in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer methodology for estimating the net realizable value of DOD EOU inventory and OM&S. Specifically, the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer revised the DOD FMR to require the use of the DLA net realizable value methodology before assessing whether it would result in a reasonable estimate of the Military Department EOU inventory and OM&S. Implementing recommendations B.1 and B.2 in this report will improve DOD internal controls over estimating the net realizable value of DOD EOU inventories and OM&S. We will provide a copy of the report to the senior official responsible for internal controls in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer.

# Finding A. DLA Methodology for Estimating Net Realizable Value of EOU Inventory

The DLA methodology for estimating the net realizable value for its \$5.8 billion EOU inventory is a good starting point towards bringing DLA in compliance with SFFAS No. 3. However, the DLA methodology does not produce a reasonable estimate that fully complies with SFFAS No. 3, and overstates the value of items DRMS disposes of through DOD reutilizations, transfer or donation to non-DOD organizations, and foreign military sales. The overstatements occurred because the DLA methodology:

- assigns a 100 percent recovery value for used and unused items in serviceable condition instead of lesser values specified in the DOD FMR;
- gives value to items disposed of through transfer or donation without reimbursement to other Federal agencies, state, and local governments; and
- over estimates revenues for items disposed of through the foreign military sales program.

If DLA had used its methodology for FY 2008 financial reporting, it would have overstated its EOU inventory value by approximately \$71 million. If DLA does not modify the methodology, it will overstate future estimates of DLA EOU inventory.

## DLA EOU Inventory

DLA maintains EOU inventory through its inventory control points and values the inventory at its historical<sup>±</sup> or latest acquisition cost.<sup>±</sup> Through DRMS, DLA maintains excess inventory that its inventory control points, the Military Departments, and other DOD organizations turn in. DRMS inventory is valued at an estimated historic cost, which is the acquisition value that the disposing organization records on a disposal turn-in document. DLA must revalue the EOU inventory that its inventory control points and DRMS maintain from estimated or actual historical cost to its net realizable value. Table 1 provides a breakout of the \$5.8 billion DLA EOU inventory value for FY 2008 by managing organization prior to any net realizable value adjustment.

**Table 1. DLA FY 2008 EOU Inventory at Historic Cost Value**

<b>Managing Organization</b>	<b>Inventory Value</b>
DLA DRMS	\$5,806,987,000
DLA Inventory Control Points	5,007,000
<b>Total</b>	<b>\$5,811,994,000</b>

## DLA Net Realizable Value Methodology

The DLA methodology for estimating the net realizable value for its EOU inventory is a good start towards bringing DLA in compliance with SFFAS No. 3 because DLA previously did not assign a value to these items. DLA developed a complex, multi-step, estimation methodology that calculates a net realizable value factor based on how DRMS disposed of items during the previous fiscal year. The DLA methodology applies the net realizable value factor to the EOU inventory that DLA inventory control points and DRMS maintain (see Appendix B for details on the overall methodology). DRMS personnel stated that they dispose of items using five primary means called “categories of disposition:”

- *DOD Reutilization Disposition Category<sup>±</sup>* - A DOD organization identifies a use for an item and orders it from DRMS.
- *Transfer and Donation Disposition Category<sup>±</sup>* - Other Federal agencies or state or local governments identify a use for an item and orders it from DRMS.
- *Foreign Military Sales Disposition Category<sup>±</sup>* - Foreign governments approved to receive excess Defense articles order the item from DRMS. These orders are generally grants (free-issue) but sometimes countries reimburse DOD.
- *Sold and Removed Useable Property Disposition Category<sup>±</sup>* - If DRMS is unable to dispose of an item through other means and DOD does not restrict sale to the general public, DRMS sells it to a contractor at a fixed rate and the contractor sells the item to the public.
- *Expended to Scrap Disposition Category<sup>±</sup>* - If DRMS is unable to dispose of an item through other means and DOD restricts sale to the public, DRMS sells the item as scrap material to a contractor based on current market rates.

The DLA methodology calculates estimated revenue, or recoveries, for DOD reutilizations, transfer and donations, and foreign military sales. The DLA methodology makes several assumptions when calculating estimated recoveries for these categories of disposition. In addition, the DLA methodology uses the actual revenues received for the categories of sold and removed useable property and expended to scrap. We focused on the reasonableness of the methodology and assumptions the DLA methodology used to calculate the estimated revenue, or recoveries, for DOD reutilizations, transfer and donations, and foreign military sales.

For DOD reutilizations, transfers and donations, and foreign military sales, the DLA methodology estimates a value based on the condition code<sup>±</sup> an organization assigns to an item when it turns it in to DRMS. The values are generally based on the excess material fair value<sup>±</sup> rates established in DOD FMR, volume 15, “Security Assistance Policy and Procedures,” chapter 7, “Pricing.” The DLA methodology does not always use the exact excess material fair value rate that the DOD FMR specifies for each condition code.

DOD assigns a 50 percent and 40 percent rate for condition code A-1 and A-4 items respectively; however, the DLA methodology uses a 100 percent recovery rate for condition code A-1 and A-4 items. Table 2 illustrates the item condition codes that the DLA methodology uses and the corresponding DOD FMR fair value rates<sup>2</sup> as a percentage of prices,<sup>3</sup> as well as the valuation percentages that DLA uses.

**Table 2. Item Condition Codes and DOD Valuation Percentages**

Item Condition Codes	Definitions	Valuation Percentage	
		DOD FMR	DLA
A-1	Serviceable, unused – good	50%	100%
A-4	Serviceable, used – good	40	100
B-1, C-1, D-1, B-4, C-4, D-4	Serviceable with qualification, unused in fair condition; used in good condition	30	30
D-7, E-7, F-7	Serviceable with qualification, unused in fair condition; used in good condition; unserviceable in good condition requiring minor repairs	20	20
H-7	Serviceable in poor condition; unserviceable in poor condition; unserviceable requiring minor repairs	10	10
F-X, G-X, H-X	Unserviceable, requiring major repairs	5	5

The DLA methodology calculates the estimated recoveries for the DOD reutilizations, transfers and donations, and foreign military sales disposition categories and adds them to the sold and removed usable property and expended to scrap sales. The methodology then calculates a net recovery value by subtracting DRMS annual expenses from the estimated recoveries. The methodology divides the net recovery value by the total acquisition value of all items disposed of through the five disposition categories and the resulting percentage is the “net realizable value factor.” The methodology then multiplies the net realizable value factor by the DLA fiscal year-end EOU inventory balance to arrive at an estimated net realizable value (see Appendix C for a flowchart of the DLA net realizable value methodology).

DLA applied its methodology to DLA EOU inventory for FY 2006 through FY 2008. DLA did not report the methodology results on its financial reports but instead reported an EOU inventory net value of zero for FY 2006 through FY 2008. DLA documented the details supporting each year’s calculations and net realizable value estimates. We analyzed and recalculated the estimated DLA EOU inventory balances over the same

<sup>2</sup> DOD uses more condition codes than listed in Table 2. For purposes of this report, we only list the condition codes that the DLA methodology uses.

<sup>3</sup> DLA uses the acquisition value of the item from the disposal turn-in document as the price of the item.

3-year period. Table 3 provides DLA’s net realizable value factor and EOU inventory balances for FY 2006 through FY 2008.

**Table 3. DLA Net Realizable Value Factor and EOU Inventory Net Realizable Value**

<b>Reporting Period</b>	<b>EOU Inventory Value</b>	<b>Net Realizable Value Factor*</b>	<b>EOU Inventory Net Realizable Value**</b>
FY 2006	\$7,239,827,756	3.57	\$258,240,424
FY 2007	4,926,768,142	2.65	130,595,526
FY 2008	5,811,994,000	2.21	128,190,978

\* Rounded.

\*\* These numbers are based on the unrounded DLA net realizable value factor.

## **DRMS Actual Recoveries**

DRMS actual recoveries for sales of EOU items are limited to the disposition categories of sold and removed useable property, expended to scrap, and a small portion of foreign military sales. These sales are at a significantly lesser amount than the historic cost DOD originally paid to acquire the items. For example, DRMS only recovers 1.8 percent of an item’s acquisition cost for sold and removed useable property. There are no actual recoveries for the DOD reutilization or transfer and donation disposition categories because items disposed of by these methods are given away without reimbursement. According to SFFAS No. 3, net realizable value<sup>±</sup> is the estimated amount organizations can recover from selling or disposing of items reduced by the estimated costs of completing the sale or disposal. Any potential cost avoidance or other value that the DLA methodology assigns to EOU items should be backed by evidence that will support an audit.

## **Valuation of DOD Reutilizations**

The DLA methodology for estimating the net realizable value of EOU inventory overstates the value for items DRMS disposed of through DOD reutilizations. The overstatement occurs because the DLA methodology assigns a recovery value of 100 percent of the acquisition cost for condition code A-1 and A-4 items to calculate cost avoidance to DOD, but it does not contain or reference adequate support to justify exceeding the DOD FMR 50 percent and 40 percent excess material fair value rates. In the absence of detailed support for the 100 percent cost avoidance, a more conservative estimate is appropriate. For a successful future audit of the cost avoidance associated with DOD reutilizations, DLA will need to maintain supporting documentation that auditors can review. The DLA methodology did not contain adequate support to justify exceeding the DOD FMR excess material fair value rates.

For FY 2008, the DLA methodology estimated \$565,414,547 in cost avoidance for DOD reutilizations. The DLA methodology assumes DOD organizations that reutilized condition code A-1 and A-4 EOU inventory would have otherwise purchased those items at their full acquisition cost. Therefore, the DLA methodology assumes DOD avoids the cost of the potential purchase. There is merit to DLA asserting that DOD reutilizations

represent a certain level of cost avoidance because DOD organizations can sometimes avoid purchasing new items. However, the DLA methodology lacked support to show that all DOD reutilizations of condition code A-1 and A-4 items resulted in DOD avoiding an associated event of having to purchase those same items at 100 percent of their material acquisition value.

DOD organizations reutilize EOU inventory free of charge. It is not reasonable to assume that all DOD organizations would purchase EOU items at their full acquisition value. The most probable case of a DOD reutilization where DOD actually avoids the cost of a new item occurs when a DOD inventory control point is out of stock and obtains an item from DRMS to fulfill demands. Our analysis of FY 2008 DOD reutilizations found that DOD inventory control point reutilizations represented only 10 percent of all DOD reutilizations.

In addition, a prior DOD Inspector General audit found that organizations reutilized items from DRMS without a valid requirement and did not adequately account for the items so it could be physically traced.<sup>4</sup> Because DOD organizations may not always have a documented valid requirement to reutilize an item, we cannot determine whether DOD actually avoids the associated full acquisition cost of purchasing a new item in these instances.

Considering the uncertainty surrounding the potential value of DOD reutilizations and the absence of verifiable supporting data, a more conservative valuation approach is appropriate. Specifically, the DOD FMR excess material fair value rates of 50 percent for condition code A-1 items and 40 percent for condition code A-4 items are more appropriate. Until DLA can produce sufficient data to show measurable cost avoidance associated with DOD reutilizations, the DLA methodology recovery rates should not exceed the FMR fair value rates. Table 4 illustrates our calculation of the estimated amounts for DOD reutilizations that the DLA methodology overstated for FY 2006 through FY 2008.

**Table 4. DLA Overstated Recoveries for DOD Reutilizations**

<b>Reporting Period</b>	<b>DLA Estimated Recoveries</b>	<b>Audit Estimated Recoveries</b>	<b>DLA Methodology Overstatement</b>
FY 2006	\$627,039,035	\$382,802,651	\$244,236,384
FY 2007	681,616,167	418,548,057	263,068,110
FY 2008	565,414,547	380,264,059	185,150,488

## **Valuation of Transfers and Donations**

The DLA methodology for estimating the net realizable value of EOU inventory overstates the value for transfers and donations to non-DOD organizations. The

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<sup>4</sup> DOD IG Report No. 93-132, "Condition and Economic Recoverability of Materiel in the Disposal Process," June 30, 1993.

overstatement occurs because the methodology gives value to items disposed of through transfer or donation to other Federal agencies and to state and local governments although these organizations do not reimburse DOD for the items. Unlike DOD reutilizations that have a potential economic benefit<sup>±</sup> to DOD, transfers and donations to non-DOD organizations do not represent economic benefits that DOD can obtain or control.

For FY 2008, the DLA methodology estimated \$82,440,264 in total recoveries for transfers and donations. Net realizable value is the estimated recovery amount from disposing of an item by sale or any other method. The DLA methodology includes a component to calculate estimated recoveries on items transferred and donated to other Federal agencies and to state and local governments. However, it is not reasonable to estimate a recovery for these items because they do not meet the definition of a DRMS asset.<sup>±</sup> DRMS does not actually sell them so there is no recovery amount resulting from the transaction.

For an item to meet the definition of an asset, the Federal Government entity must own it and the item must have a probable future economic benefit that the owning entity can obtain or control. An economic benefit is a benefit quantifiable in terms of money, such as revenue, net cash flow, or net income. For DOD EOU items to be deemed as assets, DRMS should dispose of them through a monetary transaction (sale) or the items should otherwise represent an economic benefit to DOD. In general, a sale is a transaction between two parties where the buyer receives goods, services, or assets in exchange for money. DRMS transfers or donates items to other Federal agencies or state and local governments without reimbursement and a sale does not occur.

It is not reasonable to estimate recoveries for items disposed of through transfer and donation because the actual recoveries are zero. In addition, there is no cost avoidance to DOD because DRMS transfers or donates these items to non-DOD organizations. Table 5 illustrates our estimated amounts for transfers and donations that the DLA methodology overstated for DLA FY 2006 through FY 2008.

**Table 5. DLA Overstated Recoveries for Transfers and Donations**

<b>Reporting Period</b>	<b>DLA Estimated Recoveries</b>	<b>Audit Estimated Recoveries</b>	<b>DLA Methodology Overstatement</b>
FY 2006	\$109,022,476	0	\$109,022,476
FY 2007	79,020,224	0	79,020,224
FY 2008	82,440,264	0	82,440,264

## **Valuation of Foreign Military Sales**

The DLA methodology for estimating the net realizable value of EOU inventory overstates the value for foreign military sales. The overstatement occurs because the DLA methodology over estimated sales revenues for items disposed of through the foreign military sales program.

For FY 2008, the DLA methodology estimated \$39,125,133 in total recoveries for foreign military sales. Section 2321, title 22, United States Code, authorizes the President to transfer excess Defense articles (EOU items) to certain countries approved for military assistance programs only if such articles are drawn from existing DOD stocks and funds available to the DOD for the procurement of defense equipment are not expended in connection with the transfer. Excess Defense articles can be transferred either on a grant basis (without reimbursement for the item) or on a sales basis (with reimbursement). Further, section 2321, title 22, United States Code specifies that a grant basis is the preferred basis because of the potential foreign policy benefit to the United States.

While items disposed of by grant through military assistance programs represent political capital for the United States, these items do not represent assets because the United States donates them to other countries without reimbursement. Therefore, it is not reasonable to assign a net realizable value to these items because they do not represent an economic benefit that DOD can obtain or control.

Nearly all of the transactions DRMS recorded as foreign military sales during FY 2006 through FY 2008 represented grants. In addition, for the few transactions that did represent sales, the sales were significantly less than the valuation factors applied by the DLA methodology. To test the reasonableness of the DLA methodology for estimating the value of foreign military sales, we obtained the actual DRMS sales revenues for FY 2006 through FY 2008 and compared those figures to the DLA estimated sales values. Table 6 illustrates the results of this comparison.

**Table 6. DLA Overstated Recoveries for Foreign Military Sales**

<b>Reporting Period</b>	<b>DLA Estimated Sales</b>	<b>Audit Identified Actual Sales*</b>	<b>DLA Methodology Overstatement</b>
FY 2006	\$43,414,603	\$304,235	\$43,110,368
FY 2007	32,675,185	119,210	32,555,975
FY 2008	39,125,133	108,313	39,016,820

\* Based on actual DRMS sales revenues.

DRMS actual sales revenue<sup>5</sup> represented less than one percent of the DLA methodology estimated sales value for FY 2006 through FY 2008. Because DRMS receives very little actual return on its foreign military sales program, the DLA methodology over estimated the net realizable value for the related items. Because the DLA methodology relies heavily on the previous fiscal years disposal operations to estimate future recoveries, it is not reasonable to use estimates for foreign military sales values when actual sales revenues are available.

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<sup>5</sup> Actual sales revenue includes a 3.5 percent packaging, crating, and handling fees charged on most sales. Actual sales for FYs 2006 through 2008, excluding fees, were \$172,735, \$2,209, and \$1,313, respectively. DRMS transfers this revenue to the Defense Security Cooperation Agency.

## Financial Reporting Impact

If DLA had used its methodology for FY 2008 financial reporting, it would have overstated its EOU inventory value by approximately \$71 million (see Table 8 for details). DLA's overestimated recoveries for DOD reutilizations, transfers and donations, and foreign military sales cause an overstatement of the DLA net realizable value factor. We recalculated the DLA net realizable value factor for FY 2006 through FY 2008 based on our audit adjustments for DOD reutilizations, transfers and donations, and foreign military sales. Table 7 illustrates the annual impact of our audit adjustments.

**Table 7. Annual Impact of Audit Adjustments on DLA Net Realizable Value Factor**

Reporting Period	DLA Net Realizable Value Factor*	Audit Net Realizable Value Factor*	Net Realizable Value Factor Variance
FY 2006	3.57	1.55	-2.02
FY 2007	2.65	1.19	-1.46
FY 2008	2.21	0.99	-1.22

\*Rounded

The DLA methodology multiplies the net realizable value factor by the EOU inventory value to arrive at the estimated net realizable EOU inventory balance. Table 8 illustrates the annual impact that our audit adjustments to the estimated values for DOD reutilizations, transfers and donations, and foreign military sales had on the DLA estimated EOU inventory net realizable value for FY 2006 through FY 2008.

**Table 8. Annual Impact of Audit Adjustments on DLA Estimated EOU Inventory Net Realizable Value**

Reporting Period	DLA EOU Inventory Value*	DLA Net Realizable Value*	Audit Net Realizable Value**	DLA Methodology Overstatement
FY 2006	\$7,239,827,756	\$258,240,424	\$112,363,209	\$145,877,215
FY 2007	4,926,768,142	130,595,526	58,769,494	71,826,032
FY 2008	5,811,994,000	128,190,978	57,683,784	70,507,194

\* Amounts from Table 3.

\*\* Amounts calculated for each fiscal year using the unrounded audit net realizable value factor in Table 7.

## Conclusion

If DLA does not modify its methodology, it will overstate future estimates of DLA EOU inventory. The DLA methodology makes some questionable assumptions and DLA should refine it to bring it in full compliance with SFFAS No. 3. The DLA methodology lacked support for the cost avoidance amounts associated with the DOD reutilization program and did not use actual recoveries for the transfer and donation and foreign military sales programs. DLA needs to modify its methodology for estimated recoveries

associated with DOD reutilizations, transfers and donations, and foreign military sales if it plans to use it for financial reporting purposes.

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

**A. We recommend that the Director, Defense Logistics Agency, modify the existing Defense Logistics Agency net realizable value methodology and apply these guidelines:**

**1. Develop supporting documentation for the cost avoidance amounts associated with DOD reutilizations of A-1 and A-4 condition code items. Until the development of more appropriate information to value DOD reutilization cost avoidances, use the DOD Financial Management Regulation excess material fair value rates as a basis for determining and applying a fair value percentage for DOD reutilizations of A-1 and A-4 condition code items.**

### ***Management Comments***

The DLA Director of Financial Operations and Chief Financial Officer commented for the DLA Director and disagreed with the recommendation. He stated that we [DODIG] acknowledged that entities which reutilize DLA EOU inventory avoid the cost of purchasing new equipment. Further, he stated that the DLA methodology is based on the assumption that DOD recipients of excess material have a valid requirement and comply with existing laws and regulations. The Director concluded that all material in serviceable condition (used or unused) should be valued at 100 percent of its latest acquisition cost regardless of how it is disposed.

### ***Our Response***

The DLA comments are not responsive. DLA did choose to adopt the DOD FMR fair value rates in its estimation methodology but did not apply the rates consistently. DLA deviated from the more conservative 50 and 40 percent rates for valuing condition codes A-1 and A-4 EOU items and raised them to 100 percent without any supporting justification. DRMS disposes of EOU material to DOD organizations through the reutilization process without reimbursement and there is no actual recovery. We acknowledged that a DOD inventory control point might avoid the cost of a new item when it is out of stock and an item from DRMS can fulfill demands. However, DOD inventory control point reutilizations represented only 10 percent of all FY 2008 DOD reutilizations. We do not believe that it is reasonable for DLA to assume that all DOD organizations that reutilize “free issue” EOU items would otherwise purchase the items at their full acquisition value and that DOD avoids an associated cost in all instances. We believe that if DLA is going to make this assumption it should have data to support its position and maintain this data to support an audit. We request that DLA reconsider its position on Recommendation A.1 and provide additional comments in response to the final report.

**2. Use actual recovery amounts for transfers and donations.**

**3. Use actual recovery amounts for foreign military sales.**

### ***Management Comments***

The DLA Director of Financial Operations and Chief Financial Officer commented for the DLA Director and disagreed with the recommendations. He stated that DLA must follow the Federal Accounting Standards Advisory Board's guidance, which defines net realizable value as "the estimated amount that can be recovered from selling or any other method of disposing of an item." He further stated that, based on the guidance specified in the DOD FMR, volume 15, chapter 7, the best value estimate of what can be recovered from selling DLA excess inventory that is not in A-1 or A-4 condition code is the DOD FMR fair value rate.

### ***Our Response***

The DLA comments are not responsive. DLA developed a methodology for estimating the net realizable value of its EOU material at year-end that is predicated on the results of the DRMS disposal operations during the previous year. For the sold and removed – usable property and expended to scrap disposition categories, the DLA methodology uses the actual DRMS sales revenue from the prior year to estimate what can be recovered for the material remaining at year-end. In contrast, for the transfer and donations and foreign military sales disposition categories, the DLA methodology uses estimated recoveries and sales revenues that are materially greater than the actual DRMS recoveries and sales revenues. The DOD FMR, volume 15, chapter 7, provides guidance for pricing excess material for foreign military sales. However, DRMS only disposes of a small portion of its excess material through actual foreign military sales, so the true amount that "can be recovered" is minimal based on actual historical sales data. It is unreasonable to use estimated sales revenues in place of actual revenues, especially when the actual revenues are known and vary materially from the estimate. Specifically, DRMS data shows that actual recoveries for items disposed of through transfer and donation are zero and actual sales revenues for items disposed of through foreign military sales represented less than one percent of the DLA methodology estimated sales revenue. Therefore, DLA is overstating the value of its EOU inventory by estimating values when actual recoveries are known to be minimal. We request that the DLA reconsider its position on Recommendations A.2 and A.3 and provide additional comments in response to the final report.

## Finding B. Application of the DLA Net Realizable Value Methodology to DOD Military Department EOU Inventory and OM&S

The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer revised the DOD FMR to require the use of the DLA net realizable value methodology before assessing whether it would result in a reasonable estimate of the \$5.2 billion Military Department EOU inventory and OM&S. The policy revision was premature because DOD did not evaluate whether the composition of DRMS EOU inventory was representative of Military Department EOU inventory and OM&S. As a result, future estimates of Military Department EOU inventory and OM&S could be materially misstated.

### DOD Military Department EOU Inventory and OM&S

The Military Departments maintain EOU inventory through their respective inventory control points and DOD policy requires them to value the inventory at historical or latest acquisition cost until they revalue it to net realizable value or turn it over to DRMS. The Military Departments also report OM&S that are maintained throughout their respective field units and organizations. The Military Departments eventually dispose of EOU inventory and OM&S through DLA's DRMS. At the end of a financial reporting period, the Military Departments report on-hand EOU inventory and OM&S that they have not turned over to DRMS. The Military Departments must revalue this EOU inventory and OM&S from historical cost or latest acquisition cost to net realizable value. Table 9 illustrates the values of Military Department EOU inventory and OM&S as of September 30, 2008.

**Table 9. FY 2008 Military Department EOU Inventory and OM&S at Historical Cost Value**

<b>Military Department</b>	<b>Inventory Value</b>	<b>OM&amp;S Value</b>	<b>Total Value</b>
Army	\$546,527,000	\$737,202,000	\$1,283,729,000
Navy	930,548,000	597,471,000	1,528,019,000
Air Force	472,249,000	1,904,436,000	2,376,685,000
<b>Totals</b>	<b>\$1,949,324,000</b>	<b>\$3,239,109,000</b>	<b>\$5,188,433,000</b>

As of September 30, 2008, DOD reported approximately \$11.3 billion of EOU inventory and OM&S. As shown in Table 9, the Military Departments (Army, Navy, and Air Force) combined reported approximately \$5.2 billion, or 46 percent. DRMS reported approximately \$5.8 billion, or 51 percent (see Table 1 on page 4).

## **DOD Net Realizable Value Methodology**

The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer revised the DOD FMR to require the use of the DLA net realizable value methodology before evaluating whether the composition of DLA EOU inventory was representative of Military Department EOU inventory and OM&S. The composition of DLA EOU inventory is not representative of Military Department EOU inventory and OM&S.

DLA developed a methodology to estimate the net realizable value of its EOU inventory. In February 2009, DLA briefed its methodology to officials from the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. In May 2009, the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer updated the DOD FMR, volume 4 “Accounting Policies and Procedures,” chapter 4, “Inventory and Related Property,” to include the DLA methodology for use by all DOD organizations to estimate the net realizable value of DOD EOU inventory and OM&S. See Appendix B for the details on the DOD methodology.

As discussed in Finding A, the DLA methodology calculates a net realizable value factor based on the calculation of DRMS net recoveries. The DOD methodology applies this factor to the Military Department’s EOU inventory and OM&S. Before the revision, the DOD FMR specified valuing EOU inventory and OM&S at its net realizable value. For inventory, the DOD FMR specified that the net realizable value was zero. For EOU OM&S, DOD did not specify a net realizable value. The Military Departments reported EOU OM&S at a net value of zero, which was consistent with their treatment of inventory.

### ***Composition of DOD Inventory***

The DOD methodology does not consider the significant differences in the composition of Military Department and DRMS EOU inventory. Specifically, the value of items DOD inventory control points<sup>6</sup> turned in only represented about 7 percent of total DRMS disposals and the condition of items DOD inventory control points turned in was better than the items other DOD organizations turned in to DRMS.

The DOD methodology requires the Military Departments to value their EOU inventory using the DLA net realizable value factor, which DLA calculates based on the inventory that DRMS manages. However, the composition of inventory that DRMS manages is not representative of the EOU inventory that the Military Departments maintain through their own inventory control points. DRMS inventory only consists of a small percentage of inventory that all DOD inventory control points turn in to DRMS. Specifically, DRMS transaction files identifying the disposition of EOU items in FY 2008 showed that the \$1.9 billion value of items DOD inventory control points turned in represented only approximately 7 percent of \$28.3 billion total value for items that DRMS processed for disposal. Based on this small percentage, it is not reasonable to use the composition of

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<sup>6</sup> DOD inventory control points discussed in this section of the report consist of DLA and Military Department inventory control points.

all DRMS inventory as a basis for valuing all EOU inventory that the Military Departments maintain through their own inventory control points.

DRMS inventory other than items that DOD inventory control points turn in consists of EOU equipment and other serviceable and unserviceable items that Military units and other DOD organizations turn in. Equipment items are different from inventory items because equipment items are not held for sale. Equipment items lose value, or depreciate, over their expected useful life and may have lost some or all of their value when DOD organizations turn them in to DRMS.

Items that other DOD organizations turn in are also not necessarily representative of the items that DOD inventory control points turn in to DRMS and may not be in as good of a condition. Table 10 illustrates the comparison, by item condition code grouping, of the value of non-scrap material DOD inventory control points turned in to DRMS to the value of items other DOD organizations turned in to DRMS.

**Table 10. Condition and Value of Non-Scrap Material  
DOD Organizations Turn In to DRMS**

<b>Item Condition Codes</b>	<b>Inventory Control Point Value</b>	<b>Percent of Total Value</b>	<b>Other DOD Organization Value</b>	<b>Percent of Total Value*</b>
A-1	\$117,228,849	26%	\$695,043,786	13%
A-4	50,083,962	11	565,126,446	11
B-1, C-1, D-1, B-4, C-4, D-4	9,206,951	2	301,605,541	6
D-7, E-7, F-7, G-7	204,028,450	45	1,684,101,846	31
H-7	22,732,200	5	1,441,036,844	27
F-X, G-X, H-X	49,507,208	11	690,306,931	13
<b>Totals</b>	<b>\$452,787,620</b>		<b>\$5,377,221,394</b>	

\* Rounded.

As shown in table 10, the condition of items DOD inventory control points turned in was generally better than the material other DOD organizations turned in to DRMS. Of the total value of items DOD inventory control points turned in to DRMS:

- 37 percent were classified as serviceable in condition code A-1 and A-4, and
- 16 percent were classified as unserviceable salvage (condition codes F-X, G-X, and H-X) and unserviceable condemned (condition code H-7).

In contrast, of the total value of items other DOD organizations turned in to DRMS:

- 24 percent were classified as serviceable in condition code A-1 and A-4, and
- 40 percent were classified as unserviceable salvage (condition codes F-X, G-X, and H-X) and unserviceable condemned (condition code H-7).

Considering the differences in the condition of items turned in to DRMS by DOD inventory control points and other DOD organizations, it is not appropriate to use a net realizable value factor derived from all of DRMS inventory to value the EOU inventory that the Military Departments maintain through their inventory control points.

### ***Composition of Military Department OM&S***

The DOD methodology does not consider the significant differences in the composition of DLA EOU inventory and the Military Departments EOU OM&S. Military Department OM&S include:

- munitions, tactical missiles, and torpedoes;
- spare and repair parts held for use in maintaining military equipment;
- principal items such as uninstalled aircraft and missile engines, shipboard hull, mechanical and electronic equipment, aerial targets and drones; and
- assets held for potential reuse within the DOD Component.

Munitions and tactical missiles represented approximately \$106 billion, or 69 percent, of the value of OM&S reported on the Military Department's FY 2008 financial statements. More significantly, as illustrated in Table 11, munitions and tactical missiles represented approximately 91 percent of the FY 2008 Military Department EOU OM&S.

**Table 11. FY 2008 DOD Excess, Obsolete, and Unserviceable OM&S**

<b>Military Department</b>	<b>EOU OM&amp;S Value</b>	<b>EOU Munitions and Missile OM&amp;S Value</b>	<b>Percent of EOU Munitions and Missile Value to EOU OM&amp;S Value</b>
Army	\$737,202,078	\$737,202,078	100
Navy	597,471,024	380,454,009	64
Air Force	1,904,436,000	1,830,609,249	96
<b>Totals</b>	<b>\$3,239,109,102</b>	<b>\$2,948,265,336</b>	<b>91</b>

DRMS does not accept ammunition, explosives, and dangerous articles. The Military Departments dispose of munitions and tactical missiles through the U.S. Army Joint Munitions Command instead, which manages the demilitarization or destruction of most munitions and tactical missiles. The DOD methodology requires the Military Departments to value EOU OM&S using the DLA net realizable value factor. DLA calculates its net realizable value factor based on the inventory that DRMS manages,

which excludes munitions and tactical missiles. Therefore, it is not appropriate to use the DLA net realizable value factor to value Military Department EOU OM&S, which is comprised almost entirely of munitions and tactical missiles.

## **Conclusion**

The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer revised the DOD FMR to require the use of the DLA net realizable value methodology before assessing whether it would result in a reasonable estimate of the \$5.2 billion Military Department EOU inventory and OM&S. The policy revision was premature because DOD did not evaluate whether the composition of DRMS EOU inventory was representative of Military Department EOU inventory and OM&S. The Under Secretary of Defense (Comptroller)/Chief Financial Officer should consider the differences in the composition of DRMS and Military Department inventory and OM&S and pursue additional net realizable value estimation methodologies. Delaying the implementation of the DOD FMR requirement for DOD organizations to use the DLA methodology to estimate the net realizable value of DOD EOU inventories and OM&S can prevent future misstatements of DOD EOU inventory and OM&S.

During the audit, Military Department personnel involved with inventory financial reporting also cited concerns with the DOD net realizable value methodology. DOD should coordinate with the Military Departments and the U.S. Army Joint Munitions Command to develop appropriate methodologies for estimating net realizable values based on the unique composition of each respective organization's EOU inventory and OM&S.

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

**B. We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer suspend implementation of the provisions in DOD 7000.14-R, "DOD Financial Management Regulation," volume 4, "Accounting Policies and Procedures," chapter 4, "Inventory and Related Property," for valuing excess, obsolete, and unserviceable inventory and operating materials and supplies held by the Military Departments and:**

### ***Management Comments***

The Deputy Chief Financial Officer commented for the Under Secretary of Defense (Comptroller)/Chief Financial Officer and agreed with the recommendation. He stated that they would suspend implementation of the policy for the Military Departments until they could develop an appropriate methodology to value EOU inventory, operating materials and supplies, and munitions and tactical missiles.

### ***Our Response***

The Deputy Chief Financial Officer's comments are responsive, and no additional comments are required.

**1. Coordinate with the Military Departments to develop a methodology to value Military Department excess, obsolete, and unserviceable inventory and operating material and supplies other than munitions.**

***Management Comments***

The Deputy Chief Financial Officer commented for the Under Secretary of Defense (Comptroller)/Chief Financial Officer and agreed with the intent of the recommendation. He proposed to use DRMS information to calculate a separate factor for estimating the net realizable value of EOU inventory and OM&S held by the Military Department inventory control points. The factor will not be used to calculate the net realizable value of principal items, munitions and tactical missiles, or engines classified as OM&S.

***Our Response***

The Deputy Chief Financial Officer's comments are responsive, and no additional comments are required.

**2. Coordinate with the U.S. Army Joint Munitions Command to develop a methodology for establishing the net realizable value for excess, obsolete, and unserviceable munitions and tactical missiles.**

***Management Comments***

The Deputy Chief Financial Officer commented for the Under Secretary of Defense (Comptroller)/Chief Financial Officer and agreed with the recommendation. He stated that he will be able to provide an estimated completion date by the end of the second quarter 2010, once he obtained more information about the disposal process of EOU munitions and tactical missiles.

***Our Response***

The Deputy Chief Financial Officer's comments are responsive, and no additional comments are required.

## **Appendix A. Scope and Methodology**

We conducted this performance audit from June 2009 through December 2009. We performed the audit at the request of the Under Secretary of Defense (Comptroller)/Chief Financial Officer. In the request for audit, the Under Secretary of Defense (Comptroller)/Chief Financial Officer asked that we limit our objective to determining whether the methodology and assumptions provide an acceptable estimate of the net realizable value for financial reporting and is in accordance with generally accepted accounting principles. The request also specified that the review would not be to determine if the data set is traceable to source documentation. We agreed and adjusted our objective and scope accordingly. For example, we did not perform detailed tests to verify the reported EOU inventory and OM&S balances; DRMS reutilization, transfer and disposal amounts; item condition code; or cost avoidances associated with DOD reutilizations.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We performed the audit at DLA headquarters and DRMS. In addition, we made inquiries to Military Department officials involved with the inventory and operating materials and supplies reporting processes. We obtained and reviewed the SFFAS and DOD FMR guidance for valuing EOU inventory and OM&S at their net realizable value.

We obtained DLA summary data necessary for us to perform the DLA net realizable value calculation for FY 2006 through FY 2008. We obtained and analyzed the individual DRMS transaction data for FY 2008. We analyzed and separated the inventory control point and non-inventory control point transactions and summarized acquisition values for each data set by disposition category and condition code. We obtained the actual foreign military sales data and compared the data to the estimated sales to determine the reasonableness of using foreign military sales estimates to calculate the net realizable value factor.

### **Use of Computer-Processed Data**

The DOD methodology for calculating the net realizable value factor relies on data extracted from the DRMS Automated Information System. We analyzed this data only to determine whether the DOD methodology and assumptions provide an acceptable estimate of the net realizable value for financial reporting and is in accordance with generally accepted accounting principles. Because of our limited audit objectives and scope we did not determine the reliability, completeness, or accuracy of the data and this did not materially affect our findings, conclusions, or recommendations.

## **Use of Technical Assistance**

The DOD Office of Inspector General, Quantitative Methods and Analysis Division provided assistance in reviewing the mathematical calculations in the spreadsheets DLA used to calculate the FY 2008 net realizable value for its inventory.

## **Prior Coverage**

No prior coverage has been conducted on DOD valuation of excess, obsolete, and unserviceable inventory and operating materials and supplies during the last 5 years.

# Appendix B. DOD Net Realizable Value Methodology

progress. If it will not be incorporated into in-house work it should be recorded to inventory available for sale.

3. Inventory Work-in-process (Other Government Activities).

Inventory Work-in-process (Other Government Activities) is used to record the cost of work-in-process performed by other federal government agencies. A subsidiary account must be maintained for each contract to track the value of work performed as represented by progress payments. Sources for entries to this account include interagency agreements, invoices, payment vouchers, property acceptance documents, and documented losses.

4. Inventory Work-in-process (Government-Furnished Material (GFM))

a. Inventory Work-in-process (GFM) is used to record the value of that portion of government material furnished to contractors and subcontractors (including other federal agencies) for the performance of DoD contracts. For the purposes of this chapter, this requirement also extends to property furnished to other Federal agencies and third-parties.

b. A subsidiary account must be maintained for each contractor that is furnished government property for use in performance of a contract(s) and that is to be returned upon completion of the contract. The subsidiary accounts must be subdivided by contract. Increases to this account must be supported by documentation evidencing issues of government material to contractors, whether from inventory or from another contractor in accordance with DoD instructions. Decreases to this account only occur when the end item is accepted by the DoD and received into inventory, or the material is returned to inventory or otherwise disposed of at DoD's direction.

c. Periodically, but at least annually, this account must be reconciled with the property accountability records maintained by the contractor. This reconciliation involves coordination with the assigned property administrator for the contract. Property administrators must be provided financial data on the value of GFM for use in completing contract close out or termination. On contract completion or termination the account must be adjusted to reflect the disposition of unused GFM provided to the contractor for use in meeting contractual requirements.

d. Sources for entries to this account include shipping and issue documents, property acceptance documents and property administrator reports, material-return documents, collection and deposit documents, settlement agreements, and documented losses.

0408 DETERMINING NET REALIZABLE VALUE

040801 Net Realizable Value Factor. The Defense Reutilization and Marketing Service (DRMS) must annually calculate the factor for estimating the net realizable value of excess, obsolete, and unserviceable (EOU) inventory or OM&S using

the instructions at 040803 and the format at 040804. The calculation must be as of September 30 of the fiscal year just completed. DRMS will base the factor on experience for the fiscal year just ending plus the 2 years preceding the fiscal year ending September 30, 20XX. DRMS must submit the factor, along with supporting documentation, to the Office of the Under Secretary of Defense(Comptroller), Accounting and Finance Policy and to the Office of the Under Secretary of Defense (Logistics and Material Readiness) by the 6<sup>th</sup> working day of October—followed by a hard copy that is certified correct by the DLA Comptroller.

040802 Factor Availability. For financial statement reporting, the factor will be posted with the financial reporting instructions on the OUSD(Comptroller) web site. *(Financial Reporting Guidance)* The same factor must be used for reporting the value of excess, obsolete, and unserviceable inventory for the first three quarters of the subsequent fiscal year. Steps 1-11 apply only to DRMS while Steps 12 and 13 apply to all Military Departments and Components.

040803. Instructions for Calculation of Net Realizable Value Factor. Instructions (Steps) for performing the calculations using the template at 040804 are set forth in steps.

A. **Step 1:** For the current and two previous years, obtain DRMS' Sales Revenue and DRMS' combined expense amount for DoD Reutilizations, Transfers & Donations and Foreign Military Sales. Each of the amounts called for in the subsequent steps will be the sum of the current and previous two years data.

B. **Step 2:** Obtain the cumulative acquisition values of the major disposition activities as described in B1-B5, excluding from these activities the categories of Abandoned or Destroyed, Ultimate Disposals and Other Dispositions.

1. DoD Reutilization
2. Transfers and Donations
3. Foreign Military Sales
4. Sold and Removed – Usable Property
5. Expended to Scrap

C. **Step 3:** Sum the acquisition values of the major disposition activities listed in B1 through B5 of Step 2 to arrive at Total Dispositions Excluding Liabilities and enter the result.

D. **Step 4:** Obtain the cumulative acquisition values by condition code for the three unilateral or non-exchange disposition activities in D1-D3.

1. DoD Reutilization
2. Transfers and Donations
3. Foreign Military Sales

E. **Step 5:** Next, pool the acquisition values for each condition code (E1-E5) in accordance with the classifications contained in the FMS Pricing Regulation (*FMR Volume 15, Chapter 7*, paragraph 070304).

1. A-1 (serviceable, unused)
2. A-4 (serviceable, used)
3. B-1, B-4, C-1, C-4, D-4 (serviceable with qualification)
4. D-7, E-7, F-7, G-7 (serviceable with qualification)
5. H-7 (serviceable or unserviceable, in poor condition)
6. F-X, G-X, H-X (unserviceable, requiring major repairs)

F. **Step 6:** Subtract the sum of the condition code data for DoD Reutilization, Transfers and Donations, and Foreign Military Sales from the corresponding year-end totals of these dispositions. That is, subtract the step 4 amounts from the step 2 amounts and enter the results.

G. **Step 7:** DoD Reutilizations, Transfers and Donations, and Foreign Military Sales should be valued at fair value. The fair value of excess, obsolete, and unserviceable (EOU) inventory to DLA should be no less than the revenue that DoD could have received for the EOU item by directing it to Foreign Military Sales. (See *FMR Volume 15, Chapter 7*, paragraph 070304)

1. Use the latest acquisition cost as fair value of serviceable used and unused materiel (A-1, A-4) under Reutilization, Transfers and Donations, and Foreign Military Sales.

2. Use the FMS percentage factor for condition codes (B-1, C-1, D-1, B-4, C-4, D-4) (*FMR Volume 15, Chapter 7*, paragraph 070304) apply the factor to the acquisition cost under the Reutilization, Transfers and Donations, and Foreign Military Sales headings.

3. Use the FMS percentage factor for condition codes (D-7, E-7, F-7, G-7) (*FMR Volume 15, Chapter 7*, paragraph 070304) apply the factor to the acquisition cost under Reutilization, Transfers and Donations, and Foreign Military Sales.

4. Use the FMS percentage factor for condition code (H-7) (*FMR Volume 15, Chapter 7*, paragraph 070304) apply the factor to the acquisition cost under the Reutilization, Transfers and Donations, and Foreign Military Sales headings.

5. Using the FMS percentage factor for condition codes (F-X, G-X, H-X) (*FMR Volume 15, Chapter 7*, paragraph 070304) apply the factor to the acquisition cost under the Reutilization, Transfers and Donations, and Foreign Military Sales headings.

H. **Step 8:** Allocate DRMS' Sales Revenue from Step 1 by the ratio of acquisition cost of Sold and Removed to Expended to Scrap.

I. **Step 9:** Sum all recoveries from Steps 7 and 8 within each major disposition activity, e.g., “DoD Reutilization,” and across all major disposition activities.

J. **Step 10:** Subtract DRMS’ Expenses (RTDS) from the sum of all recoveries computed in Step 8 to arrive at DRMS’ Net Recovery.

K. **Step 11:** Divide Net Recovery from Step 10 by Total Dispositions Excluding Liabilities from Step 3 to generate the NRV Factor.

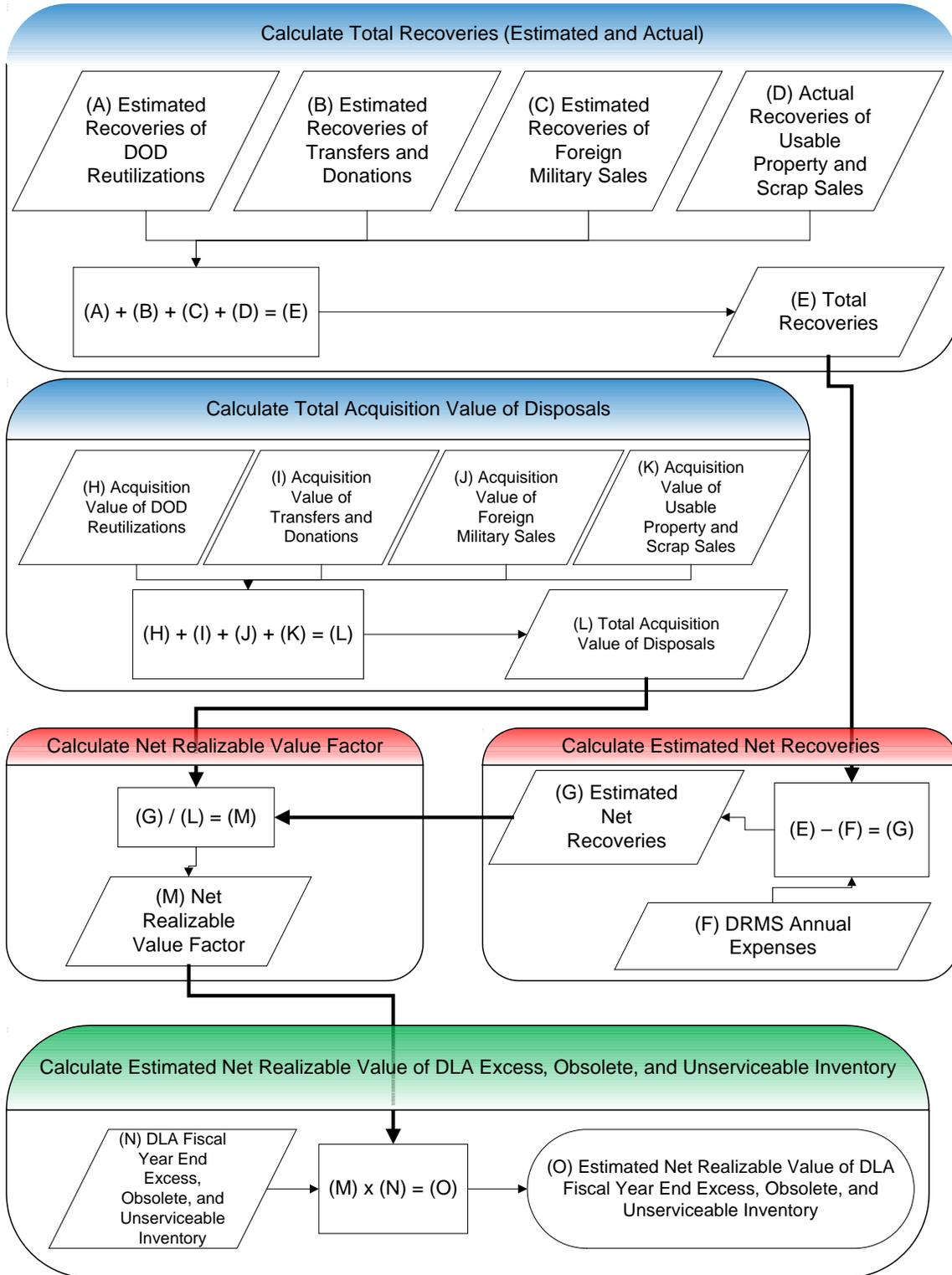
L. **Step 12:** Obtain the EOU inventory balance on September 30, 20XX. (Each reporting entity will have to use the factor derived in step 11 to calculate the value of its EOU.)

M. **Step 13:** Compute the NRV of the EOU inventory held at year-end by multiplying the NRV Factor in Step 11 the EOU inventory held at year-end in Step 12. (Each reporting entity will have to use the factor derived in step 11 to calculate the value of its EOU.)

040804. The Template for Calculating Net Realizable Value Factor—is shown on the next page.

<b>Methodology for Calculating Net Realizable Value</b>						
<b>NRV TEMPLATE</b>						
<b>Data Source</b>	<b>Part 1: Expenses and Recovery</b>					
GLAC 457912*	DRMS Sales Revenue	Step 1				
DRMS Expense Report	DRMS Expenses -- RTDS					
		<b>Annual Cumulative Acquisition Values of DRMS Dispositions</b>		<b>DRMS Annual Recoveries</b>		
		<b>Disposition</b>	<b>Acquisition Value</b>	<b>Foreign Military Sales Percent**</b>	<b>Sales Revenue or Cost Avoidance**</b>	<b>Total Recoveries by Type</b>
	DAISY A0530	DoD Reutilization	Step 2			
		DAISY Adjustment	Step 6			
		Serviceable, unused (A-1)	Step 4	Step 7	Step 7	
		Serviceable, used (A-4)				
		Serviceable with qualification (B-1, C-1, D-1, B-4, C-4, D-4)				
		Serviceable with qualification (D-7, E-7, F-7, G-7)				
		Serviceable, in poor condition (H-7)				
		Unserviceable, requiring major repairs (F-X, G-X, H-X)				Step 9
	DAISY A1050	Transfers and Donations	Step 2			
		DAISY Adjustment	Step 6			
		Serviceable, unused (A-1)	Step 4	Step 7	Step 7	
		Serviceable, used (A-4)				
		Serviceable with qualification (B-1, C-1, D-1, B-4, C-4, D-4)				
		Serviceable with qualification (D-7, E-7, F-7, G-7)				
		Serviceable, in poor condition (H-7)				
		Unserviceable, requiring major repairs (F-X, G-X, H-X)				Step 9
	DAISY A1010	Foreign Military Sales	Step 2			
		DAISY Adjustment	Step 6			
		Serviceable, unused (A-1)	Step 4	Step 7	Step 7	
		Serviceable, used (A-4)				
		Serviceable with qualification (B-1, C-1, D-1, B-4, C-4, D-4)				
		Serviceable with qualification (D-7, E-7, F-7, G-7)				
		Serviceable, in poor condition (H-7)				
		Unserviceable, requiring major repairs (F-X, G-X, H-X)				Step 9
	DAISY A1190	Sold and Removed -- Usable Property	Step 2		Step 8	
	DAISY A1450	Expended to Scrap				Step 9
	<b>Total Dispositions Excluding Liabilities</b>		Step 3			
<b>Part 2: NRV Calculation</b>						
	DRMS Annual Recoveries		Step 9	**Cost Avoidance of Foreign Military Sales (FMS) and DoD Reutilizations and Transfers and Donations taken from FMS downgrade percentages in Financial Management Regulations, Vol 17, 070304; (Cost Avoidance =		
	DRMS Annual Expenses		Step 1			
	DRMS Net Recovery (= Recoveries - Expenses)		Step 10			
	Total Dispositions Excluding Liabilities		Step 3			
	NRV Factor (= Net Recovery / Total Dispositions)		Step 11			
	EOU Inventory, DLA Balance Sheet as of 09/30/06		Step 12			
	NRV (=NRV Factor x Ending EOU Inventory)		Step 13			

# Appendix C. Flowchart of DLA Net Realizable Value Methodology





COMPTROLLER

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

JAN 22 2010

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL,  
DIRECTOR DEFENSE BUSINESS OPERATIONS

SUBJECT: Draft Audit Report, "DoD Methodology for the Valuation of Excess,  
Obsolete, And Unserviceable Inventory and Operating Materials and  
Supplies," (Project No. D2009-D000FR-0212.000)

This memorandum responds to recommendations contained in the subject report issued December 10, 2009. You requested a response on the recommendations for Finding B, which was addressed to the Under Secretary of Defense (Comptroller).

We concur with your recommendation to suspend implementation of the net realizable value methodology required by the DoD Financial Management Regulation for the Military Departments until we are able to comply with recommendations B.1 and B.2. While we agree with your logic and intent for recommendation B.1, we propose that we have the flexibility to consider an alternate path as set forth in the attachment to this memorandum. We accept recommendation B.2 without condition.

My point of contact is [REDACTED] He can be reached by telephone at [REDACTED] or email at [REDACTED]

Mark E. Easton  
Deputy Chief Financial Officer

Attachment:  
As stated



Office of the Under Secretary of Defense (Comptroller) comments to DoD, IG draft report, "DoD Methodology for the Valuation of Excess, Obsolete, and Unserviceable Inventory and Operating Materials and Supplies, Project No. D2009-D000FR-0212.000, December 11, 2009

**Recommendation B:** We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer suspend implementation of the provisions in DOD 7000.14-R, "DOD Financial Management Regulation," volume 4, "Accounting Policies and Procedures," chapter 4, "Inventory and Related Property," for valuing excess, obsolete, and unserviceable inventory and operating materials and supplies held by the Military Departments...

**OUSD(C) RESPONSE:** The Department concurs. We will suspend implementation of the policy for Military Departments until recommendations B.1 and B.2 are closed. In the meantime, we will follow the former policy of determining NRV for the financial statements of the Military Departments, i.e., deeming NRV to be \$0.

**Recommendation B.1:** Coordinate with the Military Departments to develop a methodology to value Military Department excess, obsolete, and unserviceable inventory and operating material and supplies other than munitions.

**OUSD(C) RESPONSE:** The Department concurs with the intent of the recommendation. We intend to use information from DRMS to calculate a separate factor for estimating the NRV of EOU inventory and operating materials and supplies (OM&S) held by the Military Departments. For material classified as OM&S, this factor will not be used to calculate the NRV of principal items, munitions and tactical missiles, or engines. We will segregate the value of the ICP turn-ins and the amounts recovered from the disposal of that same inventory, whether cash or an imputed recovery, and calculate a separate NRV factor for use by the Military Department. Using this method has the advantage of consistency and transparency in the development of the factor. We will furnish an estimate of the completion date in response to the final report.

**Recommendation B.2:** 2. Coordinate with the U.S. Army Joint Munitions Command to develop a methodology for establishing the net realizable value for excess, obsolete, and unserviceable munitions and tactical missiles.

**OUSD(C) RESPONSE:** The Department concurs. Given the amount of the munitions EOU as a percent of total OM&S, i.e., approximately 69 percent of the total OM&S EOU amount reported by the Military Departments based on the data in your report, it is appropriate to develop a separate factor. However, until we obtain more information about the disposal process we cannot offer a meaningful date as to when we will close the recommendation. By the end of the second quarter, 2010 we will provide a date by which we will complete the actions needed to establish a methodology for estimating the NRV of EOU munitions and tactical missiles.



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

JAN 22 2010

IN REPLY  
REFER TO J-89

MEMORANDUM FOR DEPARTMENT OF DEFENSE OFFICE OF INSPECTOR GENERAL

SUBJECT: Draft Audit Report: Department of Defense Methodology for the Valuation of Excess, Obsolete, and Unserviceable Inventory and Operating Materials and Supplies (Project No. D2009-D000FR-0212.000).

The Defense Logistics Agency has reviewed the subject draft audit report. A copy of our response to the recommendations for Finding A is attached.

Point of contact (POC) for this action is [REDACTED] DSN [REDACTED]  
or email: [REDACTED]. The administrative POC is [REDACTED]  
[REDACTED] DSN [REDACTED] or email: [REDACTED]

J. ANTHONY POLEO  
Director, Financial Operations  
Chief Financial Officer

Attachment

**Defense Logistics Agency (DLA) Management Comments on  
Department of Defense Office of Inspector General Draft Audit Report  
DOD Methodology for the Valuation of Excess, Obsolete, and Unserviceable  
Inventory and Operating Materials and Supplies  
(Project No. D2009-D000FR-0212.000)  
Dated December 10, 2009**

**Finding A. DLA Methodology for Estimating Net Realizable Value of EOU Inventory**

**Recommendation A:** We recommend that the Director, Defense Logistics Agency, modify the existing Defense Logistics Agency net realizable value methodology and apply these guidelines:

**Recommendation A1:** Develop supporting documentation for the cost avoidance amounts associated with DOD reutilizations of A-1 and A-4 condition code items. Until the development of more appropriate information to value DOD reutilization cost avoidances, use the DOD Financial Management Regulation excess material fair value rates as a basis for determining and applying a fair value percentage for DOD reutilizations of A-1 and A-4 condition code items.

**DLA Response:** Non-concur. The DODIG acknowledges that entities which reutilize DLA excess, obsolete and unserviceable inventory in serviceable condition (used or unused) avoid the cost of purchasing new equipment. The DODIG expressed concerns with estimating the value of such inventory at the cost of new equipment (100% of Latest Acquisition Cost) without a documented valid requirement for the equipment reutilized and documented proof of the cost avoidance.

DLA's methodology is based on the assumption that laws and regulations are followed. It is not reasonable to expect DLA to police DOD recipients of excess material by verifying a bona fide need for reutilized equipment. DLA's proposed methodology is based on the presumption of a valid requirement and the assumption that reutilization occurs as a result of complying with DOD Reutilization Defense Material Disposition Manual 4160.21 Chapter 5 which states,

"DOD policy is to reutilize excess, surplus and FEPP (Foreign Excess Personal Property) to the maximum extent feasible to fill existing needs, and to satisfy needs before initiating new procurement or repair. All DOD activities shall screen available excess assets and review excess asset referrals for those assets which could satisfy valid needs."

Therefore, all material in serviceable condition (used or unused) should be valued at 100% LAC regardless of how it is disposed.

**Recommendation A2:** Use actual recovery amounts for transfers and donations.

**Recommendation A3:** Use actual recovery amounts for foreign military sales.

**DLA Response:** Non-concur. DLA agrees with the DODIG that we must follow FASAB guidance. FASAB "Statements of Federal Financial Accounting Concepts and Standards" Appendix E defines Net Realizable Value as: "The estimated amount that can be recovered from selling, or any other method of disposing of an item less estimated costs of completion, holding and disposal." Additionally, DOD FMR Volume 15, Chapter 7 070304 stipulates:

"the selling price of excess materiel, exclusive of repair or modification costs, shall be the highest of (1) its market value (which includes nonrecurring costs as computed in paragraph 070305) as hardware, or (2) its scrap value plus nonrecurring costs and the last major overhaul costs incurred ... or (3) its fair value (plus nonrecurring and pro-rated major overhaul costs) computed using the fair value rates contained in this subsection."

For that reason, the value ascribed to DLA inventory not in A1 or A4 condition, regardless of disposition method, should be its market value calculated by using percentages provided in FMR Volume 15, Chapter 7, paragraph 070304. This is the best estimate of what can be recovered from selling.

# Glossary

**Asset.** An item that is owned and has a probable economic benefit that the owning entity can obtain or control.

**Acquisition Cost or Acquisition Value.** The amount identified as the original cost or estimated replacement cost paid for property.

**Carrying Amount.** The net amount at which an asset or liability is carried on the books of account.

**Condition Code.** A two-digit code consisting of an alpha Supply Condition Code in the first digit and a numeric or alpha Disposal Condition Code in the second digit. A combination of the Supply Condition Code and the Disposal Condition Code, which most accurately describes the item's physical condition, constitutes the Federal Condition Code for reutilization program screening and review.

**Cost Avoidance or Avoidable Cost.** Action taken to reduce future costs or a cost associated with an activity that would not be incurred if the activity, such as an alternate purchase, were not performed.

**DOD Reutilization Disposition Category.** A DOD organization identifies a use for an item and orders it from DRMS.

**Economic Benefit.** A benefit quantifiable in terms of money, such as revenue, net cash flow, or net income.

**Excess (Inventory or Operating Materials and Supplies).** Inventory that exceeds the demand expected in the normal course of operations because the amount on hand is more than can be sold in the near future.

**Expended to Scrap Disposition Category.** If DRMS is unable to dispose of an item through other means and DOD restricts sale to the public, DRMS sells the item as scrap material to a contractor based on current market rates.

**Fair Value.** The price for which an asset could be bought or sold in an arm's-length transaction between unrelated parties (for example, between a willing buyer and a willing seller).

**Foreign Military Sales Disposition Category.** Foreign governments approved to receive excess Defense articles order an item from DRMS. These orders can be grants (free-issue) or the countries reimburse the DOD (sale).

**Grant.** Transactions in which one party to the transaction receives value without directly giving or promising value in return.

**Historical Cost.** All appropriate purchase, transportation, and production costs incurred to bring the and item to its current condition and location.

**Inventory.** Tangible personal property held for sale in the process of production for sale, or to be consumed in the production of goods for sale or in the provision of services for a fee.

**Inventory Control Point.** An organizational unit or activity within the DOD supply system that is assigned the primary responsibility for the material management of a group of items either for a particular Military Service or for the Department of Defense as a whole.

**Latest Acquisition Cost (as a valuation method).** A valuation method that provides that all like units be valued at the invoice price of the most recent like item purchased, less any discounts, plus any additional costs incurred to bring the item to a form and location suitable for its intended use.

**Net Realizable Value.** The estimated amount that can be recovered from selling, or any other method of disposing of an item less estimated costs of completion, holding, and disposal.

**Obsolete (Inventory or Operating Materials and Supplies).** Inventory that is no longer needed because of changes in technology, laws, customs, or operations.

**Operating Materials and Supplies (OM&S).** Tangible personal property consumed in normal operations.

**Sale.** A transaction between two parties where the buyer receives goods, services, or assets in exchange for money.

**Sold and Removed Useable Property Disposition Category.** If DRMS is unable to dispose of an item through other means and DOD does not restrict sale to the public, DRMS sells it to a contractor at a fixed rate and the contractor sells the item to the public.

**Transfer and Donation Disposition Category.** Other Federal agencies or state or local governments identify a use for an item and orders it from DRMS.

**Unserviceable (Inventory or Operating Materials and Supplies).** Damaged stock that is more economical to dispose of than to repair.





# Inspector General Department of Defense

