Evaluation Report

OFFICE OF THE INSPECTOR GENERAL

EVALUATION OF FY 1995 DEFENSE REUTILIZATION AND MARKETING SERVICE FINANCIAL DATA

Report No. 96-216 **September 4, 1996**

DEPARTMENT OF DEFENSE

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Acronyms

DBOF	Defense Business Operations Fund
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
DRMO	Defense Reutilization and Marketing Office
DRMS	Defense Reutilization and Marketing Service
FES	Front End Screening
GSA	General Services Administration
ICP	Inventory Control Point
MSC	Material Screening Code

INSPECTOR GENERAL
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September 4, 1996

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF DEFENSE
(LOGISTICS)
DIRECTOR, DEFENSE LOGISTICS AGENCY
COMMANDER, DEFENSE REUTILIZATION AND
MARKETING SERVICE

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Report No. 96-216)

We are providing this evaluation report for review and comment. We conducted the evaluation in response to a request by the former Assistant Deputy Under Secretary of Defense for Materiel Distribution Management. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, Recommendations A. and B.2. remain unresolved. We request that DLA reconsider its position regarding the unresolved recommendations, and provide completion dates for actions planned. We request that management provide comments on the final report by November 4, 1996.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation should be directed to Ms. Debra B. Murphy, Evaluation Program Director, at (703) 604-8810 (DSN 664-8810) or Lieutenant Colonel Martin J. Sierocki, Evaluation Project Manager, at (703) 604-8761 (DSN 664-8761). See Appendix F for the report distribution. The evaluation team members are listed inside the back cover.

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Report No. 96-216 **September 4, 1996**
(Project No. 6LH-9006)

Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data

Executive Summary

Introduction. This evaluation is the result of a request from the former Assistant Deputy Under Secretary of Defense for Materiel Distribution Management. Our initial objective was to evaluate the general usefulness of Defense Reutilization and Marketing Service (DRMS) revenue and expense data in making privatization decisions. The requested evaluation was not completed due to specific concerns that arose subsequently about the reliability of DRMS FY 1995 financial data. Therefore, we reannounced the project in October 1995 to review DRMS FY 1995 financial data.

Evaluation Objectives. The overall evaluation objective was to review DRMS FY 1995 financial data. The specific objectives were to determine whether the revenues and expenses reported by DRMS for FY 1995 were reliable; to determine whether DRMS reutilization had decreased at the expense of sales; and to assess whether the upward trend in DRMS sales and profitability would continue.

Evaluation Results. The DRMS reported sales revenue and operating expense data in its FY 1995 Statement of Operations that were not reliable. The same accounting deficiencies that caused us to disclaim our audit opinion on DRMS FY 1994 financial statements were still prevalent in FY 1995. As a result, DRMS financial information reported for FY 1995 contained overstated revenue and expense and cannot be relied upon for assessing its results of operations. About $9.5 million of the overstated revenue resulted because DRMS did not reimburse the Air Force $8.9 million in proceeds from the sale of demilitarized B-52 aircraft material. Also, DRMS did not reimburse the Navy $0.6 million in proceeds for the sale of demilitarized submarine scrap (Finding A).

During our limited review we could not quantify whether reutilization decreased at the expense of DRMS sales during FY 1995. However, DRMS did not have adequate controls over the use of expedited processing for disposal and sale of DRMS inventory during FY 1995. That resulted in DRMS processing approximately $2 billion (acquisition value) of property that was not authorized for expedited processing, with a significant reduction in the usual reutilization rate (Finding B).

The DRMS had not provided front end screening notifications to the inventory control points for about $1.3 billion (acquisition value) of property. In addition, DRMS denied item managers' requests for serviceable property when property was available for redistribution. As a result, the inventory control points were buying new property at the same time DRMS had serviceable property readily available for reutilization that would offset or fully satisfy those property requirements (Finding C).

The DRMS profitability estimates of $297 million in FY 1996, and an accumulated profit of $2.4 billion from FY 1996 through FY 2001 are too optimistic and predicated on achieving unrealistic levels of operation not yet realized. Declining turn-ins of property from DoD depots, unplanned large dollar value paybacks to reimbursable customers, rising FY 1996 expenses, lower than expected FY 1996 return on asset sales, and mid-year 1996 performance suggest a more realistic view of DRMS future profitability. See Appendix A for details. See Appendix D for a summary of potential benefits resulting from evaluation.

Summary of Recommendations. We recommend that the Commander, DRMS, reimburse the Air Force and Navy for all sales of reimbursable B-52 aircraft and submarine material that the Air Force and Navy turned in. Moreover, we recommend that the Commander, DRMS, establish controls to ensure that the General Services Administration authorizes all property to be processed through expedited methods; automate the current manual decision process for expedited processing by placing material screening code X assignment under the program control of the DRMS Headquarters Automated Information System; and implement a systems change request for property with material screening code X to provide a front end screening notification to comply with DoD Manual 4160.21-M, "Defense Reutilization and Marketing Manual." We recommend that the Director, Defense Logistics Agency, direct the Internal Review Office to periodically evaluate the DRMS denials of inventory control point material requests.

Management Comments. DLA concurred with the recommendation to provide front end screening notifications to inventory control points. It stated that DRMS implemented a systems change request to allow automated notices for inventory control points. DLA partially concurred with the recommendations to establish controls to ensure that all users of expedited property are authorized by the General Services Administration, and to automate the manual decision process for expedited processing. It stated that new policy guidance for DRMS was implemented that will provide adequate controls over expedited processing, and that action is ongoing to automate the manual decision process for expedited processing. DLA nonconcurred with the recommendation that DRMS reimburse sales proceeds to the Air Force and Navy for reimbursable B-52 and submarine material that Air Force and Navy organizations turned in. It stated that, because there is no statutory authority to reimburse sales proceeds to organizations that turned in appropriated property, DRMS was correct in keeping the sales proceeds. See part I for a discussion of management comments and Part III for the complete text of management comments.

Evaluation Response. The DLA comments were not fully responsive regarding the automation of the manual decision process for expedited processing. We request DLA to address the need to eliminate the requirement for local Defense Reutilization and Marketing Offices to validate GSA approved waivers, the primary cause of unauthorized expedited processing. DRMS Headquarters needs to make the code assignment and push the validated code to the field Defense Reutilization and Marketing Offices, thereby eliminating the need for Defense Reutilization and Marketing Office workers to make item-by-item validations of GSA approved waivers. Regarding the reimbursement of sales proceeds, we disagree that there is no statutory authority to reimburse proceeds to Service generators for scrap turned in when that scrap came from equipment originally purchased with appropriated funds. United States Code, title 10, section 2210 (a) provides a statutory basis for the reimbursement of sales proceeds on appropriated assets to Service generators.

We request that DLA provide additional comments and specified completion dates in response to the final report. All comments are due by November 4, 1996.

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Part I - Evaluation Results

Evaluation Background

This evaluation is the result of a request from the former Assistant Deputy Under Secretary of Defense for Materiel Distribution Management. Our initial objective was to evaluate the general usefulness of Defense Reutilization and Marketing Service (DRMS) revenue and expense data in making privatization decisions. The requested evaluation was not completed due to the subsequent emergence of spcific concerns about the reliability of DRMS FY 1995 financial data. Therefore, we reannounced the project in October 1995 to review DRMS FY 1995 financial data.

DRMS Mission. The DRMS, a field activity of the Defense Logistics Agency (DLA) is located at Battle Creek, Michigan. DRMS is responsible for reutilizing, selling, and disposing of excess and surplus personal property generated by DoD organizations. Personal property includes all types of usable, scrap, and waste material other than land and buildings. Items not reutilized within DoD are screened for possible transfer to other Federal agencies or for donation to local governments. Surplus property not reutilized is then offered for sale to the public on a competitive basis. This mission is funded through the Defense Business Operations Fund (DBOF).

DRMO Responsibility. Actual disposition of the material is accomplished by the International Sales Office in Memphis, Tennessee, and 180 Defense Reutilization and Marketing Offices (DRMOs) located worldwide at military installations. DRMOs receive, classify, segregate, demilitarize, account for and report excess material for screening, lotting, merchandizing and selling. They also dispose of hazardous material and recover precious metals from excess and surplus property. DRMOs can generate revenues locally from cash and carry and regional auction sales as well as nationally for large dollar-valued items. National sales are made by the International Sales Office for the DRMOs. DRMOs reported some national sales (those they collected for) until March 1995, when the International Sales Office totally assumed that responsibility.

Evaluation Objectives

The primary objective was to review DRMS FY 1995 financial data. The specific objectives were to:

o determine whether the revenues and expenses reported by DRMS for FY 1995 were reliable,

o determine whether DRMS reutilization has decreased at the expense of sales, and

o assess whether the upward trend in DRMS sales and profitability will continue (see Appendix A).

See Appendix B for the evaluation process and Appendix C for a summary of prior coverage related to the evaluation objectives.

Finding A. Sales Revenue and Operating Expense

The DRMS reported sales revenue and operating expense data in its FY 1995 Statement of Operations that were unreliable. The same accounting deficiencies that caused us to disclaim our audit opinion on DRMS FY 1994 financial statements were still prevalent in FY 1995.

o Sales revenue was not integrated with cash collection, accounts receivable, and inventory recordings in general ledger balances; instead sales revenue was accounted for separately and not reconciled with related general ledger balances.

o Interservice support operating expense was not recognized when incurred or validated by certification; instead, it was estimated based on obligation rates and not adjusted to actual.

As a result, DRMS financial information reported for FY 1995 contained overstated revenue and expense and cannot be relied upon for assessing its results of operations. About $9.5 million of the overstated revenue resulted because DRMS did not reimburse the Air Force $8.9 million in proceeds from the sale of demilitarized B-52 aircraft material and related engines Also, DRMS did not reimburse the Navy $0.6 million in proceeds for the sale of demilitarized submarine scrap.

Financial Background and Scope

Accounting Services. The Defense Finance and Accounting Service (DFAS) is responsible for providing accounting support for DBOF organizations. DFAS has consolidated the DRMS accounting functions, with the exception of accounting for sales transactions and overseas transactions, at the DFAS Center, Columbus, Ohio (DFAS-Columbus). DFAS-Columbus is responsible for compiling the financial statements from trial balances and other financial data. It employs the Defense Business Management System to account for DRMS DBOF revenue and expense.

FY 1994 Opinion. We were unable to render an opinion on the FY 1994 financial statements of DRMS because account balances presented on the Statement of Financial Position and Statement of Operations were based on unreliable financial data. In response to our recommendations to improve the reliability of financial management data, DRMS indicated that a number of new procedures and controls would be implemented in FY 1995 and FY 1996. Because DRMS was in the process of implementing new procedures and controls as of March 1996, we are making no recommendations at this time to improve financial procedures and controls.

FY 1995 Financial Data. The DRMS 1995 Statement of Operations disclosed a profit of about $254 million from current operations. Table 1 shows the DRMS revenues and expenses and reported profit.

Table 1. DRMS Reported FY 1995 Operating Results

	Amount (millions)
Revenues	
Public sales	$302.3
Military department billings	206.7
Hazardous materials contracts	103.6
Precious metals recovery	6.2
Support to others	2.8
Defense Environmental Restoration Act	0.3
Subtotal	**$621.9**
Expenses	- 367.5
Profit	**$254.4**

DRMS used revenue from public sales, along with the payments from the Military Departments, to pay for operating expenses. In FY 1996, DRMS expects to pay all operating expenses from public sales revenue; thus, it plans to no longer bill the Military Departments for its operating expenses.

Scope. We limited our review of DRMS financial data to public sales and operating expense. To assess the accuracy of reported public sales revenues and operating expense for FY 1995, we analyzed financial transactions made at DRMS Headquarters, the International Sales Office, and eight DRMOs. The eight DRMOs selected for review were among the DRMOs having the largest public sales in the United States for FY 1995. Because our review focused on a limited portion of the total revenues DRMS reported in FY 1995, we are making no recommendations to adjust the FY 1995 DRMS financial statement consistent with this finding.

Revenue Results

Reliability. Public sales revenue reported by DRMS for FY 1995 was not reliable. Ideally, the reliability of sales revenue should be shown through comparative analysis to, or reconciliation with, other financially linked accounts. Specifically, there should be a relationship and a means of resolving differences between that reported as sales revenue and that reported as cash collections, accounts receivable, and inventory. That relationship or revenue cycle should be held together by an accounting system based on the integrated recording of transactions from the same or related source documents. No such

relationship was in place for sales revenue reported by DRMS in prior years or in FY 1995, due to the limitations of the DoD accounting systems established for recording and reporting DRMS financial data.

The lack of a reliable, integrated accounting system required that DRMS process sales revenue, cash collections, accounts receivable and inventory transactions separately. To illustrate, in FY 1995, the International Sales Office and DRMOs provided DFAS-Columbus with bank deposit information and individual sales collection vouchers for entering into the cash collection general ledger and for reconciling with the Appropriation Control and Reporting System, the DoD system for recording cash transactions made by collection and disbursing stations for DBOF. Normally, a reconciled balance between the general ledger and the Appropriation Control and Reporting System would serve as a good basis for reporting DRMS revenue. However, as we previously reported, neither the general ledger nor the Appropriation Control and Reporting System has produced consistent, accurate, and timely information. Consequently, DRMS Headquarters provided DFAS-Columbus with official sales revenue figures separately in the form of monthly journal vouchers. The International Sales Office and DRMOs provided daily figures for the monthly journal vouchers via a computer network and referred to the data as the DBOF Report. Neither DRMS nor DFAS-Columbus established a financial tie-in, reconciliation, or audit trail between the DBOF Report and the Appropriation Control and Reporting System. In turn, they had no assurance that the information produced by either system was reliable and suitable for financial reporting.

As of September 30, 1995, DRMS had provided DFAS-Columbus with monthly journal vouchers of cash sales totaling about $285.6 million. Table 1 shows $302.2 million in public sales including accounts receivable and foreign military sales; the $285.6 million portion represents only cash collections. However, the cash collection portion was $19 million more than reported in the Appropriation Control and Reporting System based on bank deposit information and cash collection vouchers from the International Sales Office and DRMOs. Similarly, for the eight DRMOs reviewed, DRMS reported sales of $8.3 million more than recorded in its inventory accountability system.

The large variances between amounts reported for sales revenue and amounts reported for cash collections and inventory represent potential overstatements and are indicators of financial unreliability.

Overstated Revenue. Because an integrated relationship had not been established between sales and other financially linked accounts, DRMS often reported public sales revenue not earned in FY 1995. Most of the inaccuracies we identified resulted from DRMS attempts to compensate for prior year omissions and understatements and to transition from a cash to an accrual basis of accounting. DoD Guidance on Form and Content of Financial Statements for FY 1994/1995 provides:

> An item of revenue or expense related to the correction of an error in the financial statements of a prior period shall be accounted for and reported as a prior period adjustment and excluded from the determination of net income for the current period.

Overall, we identified a net overstatement of $28.2 million in reported FY 1995 DBOF sales revenue of $74.3 million reviewed. Summary details and the results of our review at DRMS Headquarters, the International Sales Office, and the eight DRMOs are in Table 2.

Table 2. Summary of Net Overstatement

Activity	Reviewed	Overstated
Headquarters	$ 6,369,247 [1]	$ 6,369,247
International Sales Office	47,209,965 [2]	20,597,211
Alameda	2,323,062	235,816
Columbus	2,239,063	101,244
Fort Lewis	3,720,838	159,733
Mechanicsburg	1,752,328	166,540
Ogden	2,576,387	(58,310)
Stockton	3,285,620	54,538
Tooele	4,361,573	318,258
Tucson	448,862	226,952
Total	**$74,286,945**	**$28,171,229**

[1]End of year adjustments.
[2]Does not include region, zone, and cash and carry revenue recorded by the eight DRMOs selected for review.

DRMS Headquarters Results. The DRMS Headquarters overstated the end-of-year DRMS DBOF account balance by $6.3 million. The overstatement occurred because of incorrect accounting for delinquent accounts receivable and prior year revenue.

Delinquent Accounts Receivable. About $2.2 million of revenue that DRMS Headquarters added to the DRMS DBOF account consisted of accounts receivable earned before FY 1995 that were delinquent. At the end of FY 1995, DFAS-Columbus sent DRMS Headquarters the balance of all delinquent accounts receivable on hand for which collection action had been initiated. DRMS Headquarters added the total of $2.2 million to the FY 1995 DRMS DBOF account balance. Officials at DRMS Headquarters explained that the delinquent accounts receivable were added to current year revenue because they were not reported as revenues in any previous fiscal years. However, the delinquent accounts did not relate to FY 1995 sales revenue but to sales made during FYs 1986 through 1994. The $2.2 million should not have been included in FY 1995 revenue.

Prior Year Revenue. About $4.1 million of revenue that DRMS Headquarters added to the DRMS DBOF revenue balance consisted of prior year or unsupported sales revenue. At the end of FY 1995, DRMS Headquarters added $4.1 million of sales revenue to the FY 1995 DRMS DBOF account balance. However, $2.1 million pertained to prior year sales and the balance of $2 million was not supported.

International Sales Office Results. The International Sales Office recorded a net overstatement of at least $20.6 million in the DRMS DBOF account during FY 1995. The International Sales Office reportedly sold about $147.2 million (49 percent of public sales) of scrap and excess material for DRMOs in FY 1995. To evaluate the accuracy of revenue recorded by the International Sales Office, we queried the local automated marketing system used to accumulate sales revenue for recording in the DRMS DBOF account; and we obtained and reviewed printouts of all prior year receivables and current year accounts receivable. Because the International Sales Office reports sales by DRMO, we also judgmentally selected for review, from the eight DRMOs we reviewed, the five largest recorded collections. For other DRMOs, we reviewed one-time contracts over $50,000 and term contracts over $100,000 that were awarded as part of 24 invitations for bid. We reviewed a total of about $47.2 million of revenue of which $20.6 million was not earned in FY 1995. The International Sales Office recorded inaccurate sales revenue because of input errors of about $0.5 million as well as incorrect accounting for DBOF activity turn-ins, reimbursables, and prior and current year receivables.

DBOF Activity Turn-ins. About $9.5 million of revenue that the International Sales Office recorded in the DRMS DBOF account should have been reimbursed to DBOF activity customers. According to the revised DoD Instruction 7310.1, "Disposition of Proceeds from DoD Sales of Surplus Personal Property", July 26, 1993, the proceeds (100 percent) from the sale of usable and scrap material that a DBOF organization turned in to a DRMO will be deposited into the account of the generating DBOF organization. In two cases involving Air Force B-52 aircraft ($8.9 million) and Navy submarines ($0.6 million), all the revenue from sales was entered into the DRMS DBOF account although the Military Components had incurred substantial demilitarization costs and should have been reimbursed. For example, in FY 1995, the International Sales Office sold $6.5 million of metal scrap and engines from B-52 aircraft located at the Tucson DRMO. The Air Force demilitarized the aircraft at the industrial fund activity of the Aerospace Maintenance and Regeneration Center. The International Sales Office recorded all the sales revenue in the DRMS DBOF account, although DRMS incurred none of the costs of demilitarization. DRMS retention of sales revenue is not only at variance with the guidance contained in DoD Instruction 7310.1, but it also contradicts specific direction that DLA provided to DRMS in response to a Navy appeal for DRMS reimbursement to the Navy.

The DLA cited DoD Instruction 7310.1 as the authorizing basis for DRMS to reimburse the Puget Sound Naval Shipyard for the revenue generated by the sale of demilitarized submarine scrap. DRMS, citing guidance contained in DoD Directive 7410.4, "Industrial Fund Policy," July 1, 1988, asserted, "...items financed with funds appropriated by annual appropriation acts, rather than by funds contained in the industrial fund itself, are not eligible for reimbursement. These include: aircraft, ships, barges, and general-purpose passenger-type vehicles. Therefore the property processed through DRMOs as a result of decommissioning, does not qualify as industrially funded property and should not be handled as reimbursable material." DLA disagreed with the DRMS position and directed that DRMS reimburse the Navy.

In an August 21, 1995, letter to DRMS, DLA cited the DoD Instruction 7310.1 requirement to reimburse 100 percent of the proceeds to the generating DBOF organization, but acknowledged that the instruction could be misinterpreted in light of a Deputy Under Secretary of Defense (Environmental Security) September 28, 1993 memorandum, "Policy for DoD Recycling." The Deputy Under Secretary's memorandum provided that items requiring demilitarization or mutilation prior to sale are not recyclable materials and the proceeds from sale are not eligible for reimbursement. As clarification, DLA interpreted the phrase "prior to sale" as meaning "by DRMS prior to disposal." In effect, DLA told DRMS that it could retain sales proceeds only when it incurred the cost of demilitarization or mutilation. Referring to the Deputy Under Secretary's memorandum, DLA stated in its letter to DRMS, "This policy allows scrap residue from items which have been demilled or mutilated by the generating activity to qualify as recyclable material."

Because the Navy demilitarized the submarines before turning over the scrap residue to DRMS for sales, the Navy was entitled to reimbursement based on the requirements of DoD Instruction 7310.1 and on the DLA interpretation of the DoD recycling policy memorandum. DLA directed DRMS to "immediately resume reimbursements of proceeds from the sale of submarine scrap at the Puget Sound Naval Shipyard." DLA further stated, "In the future, proposed departures from policy and proposed changes in long-standing practice must be supported by a business case and be elevated to HQ [Headquarters] DLA for review, in order to avoid disruption of the kind that has resulted in this case." While DRMS responded by reimbursing the Navy, an additional $0.6 million is still owed to the Navy. Despite the DLA direction, DRMS did not reimburse the Air Force for the sale of B-52 aircraft material, nor did DRMS forward a business case to DLA requesting a departure from policy. Because the Air Force demilitarized the B-52s before turning over the material residue to DRMS for sales, the $8.9 million generated by the sale of that material should be remitted to the appropriate Air Force DBOF organization account.

Reimbursables. About $1.1 million of revenue that the International Sales Office had recorded in the DRMS DBOF account had been used to reimburse either public sales customers for overpayments or industrial fund organizations for reimbursable material turned in and sold. The International Sales Office recorded all of the sales revenue in the DRMS DBOF account but did not adjust the account for reimbursements.

Prior Year Receivables. About $6.2 million of revenue that the International Sales Office recorded in the DRMS DBOF account had been earned in FY 1994. The $6.2 million should have been recorded as accounts receivable in FY 1994. According to officials at the International Sales Office, all contracts entered into the local automated marketing system in FY 1995 were reported to DRMS as FY 1995 DBOF revenue. For financial statement purposes, an adjustment should have been made to the FYs 1994 and 1995 statements.

Current Year Receivables. Current year net profit was overstated by $3.3 million because DRMS Headquarters did not properly account for defaults related to current year receivables; and the International Sales Office did not recognize other receivables as current year revenue or as valid reimbursements. In FY 1995, the International Sales Office and DRMOs recorded $11.2 million of revenue in the DRMS DBOF account as accounts receivable. Subsequently, the sales offices reported to DRMS Headquarters that a number of customers did not live up to the terms of their contracts and were in default for $3.2 million. DRMS Headquarters should have established an allowance for the doubtful accounts to reduce the receivables to net realizable value and recorded an amount as bad debt expense to offset reported revenue in excess of the allowance. For FY 1995, DRMS Headquarters added only $33,000 to its allowance for doubtful accounts and its bad debt expense account. In effect, DRMS Headquarters understated both the allowance and bad debt expense considering that $3.2 million of revenue in default would not be collected. Also, about $0.2 million of revenue that the International Sales Office should have recorded in the DRMS DBOF account was not because the revenue was collected in FY 1996. The revenue collected in FY 1996 was for FY 1995 contracts and should have been accounted for as accounts receivable and reported in the DRMS DBOF account by the International Sales Office. In addition, the International Sales Office should have accounted for about $0.3 million as a reimbursable and not recorded it as DBOF accounts receivable revenue.

DRMO Results. The eight DRMOs selected for review recorded a net overstatement of $1.2 million in the DRMS DBOF account during FY 1995. The eight DRMOs reportedly sold about $60.2 million or 20 percent of the public sales of scrap and excess material during FY 1995. Of the $60.2 million, $20.7 million was awarded and recorded locally (as region, zone, and cash and carry sales) in the DBOF account, and the International Sales Office awarded and recorded $39.5 million in the DBOF account. At the DRMOs, we analyzed source documentation for every local contract awarded in FY 1995, and recomputed the amounts each of the DRMOs should have recorded daily in the DRMS DBOF account. Overall, $1.2 million or 6 percent of the revenue that the eight DRMOs recorded was overstated. The overstatement was the result of input errors or failure to account for accounts receivable, customer defaults, and reimbursements correctly--the type of discrepancies that an integrated accounting system and reconciliations would normally detect and resolve.

Expense Results

The DRMS reported unreliable FY 1995 operating expenses for the eight DRMOs reviewed. Operating expenses for DRMS are made up of 15 categories but primarily include hazardous waste disposal ($103.6 million), interservice support from host installations ($22.1 million), the salaries and benefits of personnel ($154.5 million), and supplies ($8.7 million). Operating expense should be certified as correct and recorded when incurred. However, as in prior

years, FY 1995 operating expenses, other than waste disposal and personnel, were often recorded on the basis of obligation rates and not certified. To assess the validity of reported expense balances, we centered our review on interservice support and personnel expenses.

Interservice Support Expenses. The DRMS reported interservice support expenses that were substantially inaccurate for the DRMOs selected for review. For FY 1995, DRMS reported that DRMOs spent about $22.1 million on interservice support, of which $0.8 million was incurred by the eight DRMOs we reviewed. To determine the accuracy of interservice support expense, we compared the amount reported for interservice support in the Defense Business Management System to actual bills on hand at DRMOs. We identified a consistent pattern of overstatements resulting from the recording of expenses to match obligation rates, the untimely paying of bills or posting disbursements, and the lack of bills or certifications. However, the myriad of shortcomings prevented us from arriving at the actual interservice expense amount that should have been recorded for each DRMO, as evidenced in the following example.

The DRMS reported that Mechanicsburg incurred $765,877 in nonpersonnel costs for FY 1995. Of the nonpersonnel costs, $306,905 was accounted for as an interservice support agreement. The amount cited is overstated because of a Defense Business Management System procedure that requires the expense to equal the amount obligated at yearend. Only $199,057 could be substantiated based on disbursements recorded in the Defense Business Management System at yearend and only $157,272 could be substantiated based on actual bills on hand at Mechanicsburg. None of the balance substantiated by bills was reliable because Mechanicsburg did not certify that any of the bills were accurate based on services performed.

Personnel Expense. The DRMS reported valid personnel expenses for those organizations selected for review. For FY 1995, DRMS reported $154.5 million in personnel expenses, of which $14.2 million was incurred by the eight DRMOs we reviewed. To determine the accuracy of the reported personnel expenses, we reviewed payroll procedures and controls and analyzed the reasonableness of increases or decreases to prior year staffing levels at DRMOs. At the eight DRMOs, adequate internal controls had been established for reporting payroll and other personnel information, and the aggregated 8 percent increase in personnel expenses for FY 1995 was considered reasonable.

Summary

Sales revenue that DRMS organizations reported was generally overstated. The revenue was not integrated with cash collection, accounts receivable, and inventory recordings in general ledger balances. Instead, sales revenue was accounted for separately and not reconciled with related general ledger balances. Interservice support operating expense was not recognized when incurred or validated by certification, but was estimated based on obligation rates and not

adjusted to actual costs. As a result, the financial data DRMS reported for those organizations we reviewed cannot be relied upon for assessing the results of operations. Also, DRMS retained about $9.5 million in proceeds from the sale of demilitarized B-52 aircraft and submarine material that should have been reimbursed to the respective accounts of the Air Force and Navy DBOF organizations consistent with the guidance contained in DoD Instruction 7310.1 and in DLA policy.

Management Comments on the Finding and Evaluation Response

The DLA partially concurred with the finding. Overall, DLA attributed the unreliable FY 1995 DRMS financial data to the lack of integrated financial systems that compelled DRMS managers to make manual adjustments that were often inaccurate. DLA disagreed that estimating expenses to reflect reasonable and probable costs when expense data is not available is an incorrect application of Generally Accepted Accounting Principles.

Evaluation Response. At issue is not the method used to account for expenses but the lack of certification that resulted in the inaccurate expenses that DRMS reported during FY 1995. DRMS used procedures that required its expenses to equal the amount obligated at yearend, and did not accurately adjust the yearend expenses to actual bills. The lack of certification verifying that the bills were accurate based on services performed is the primary cause of the inaccurate expense data that DRMS reported in FY 1995.

We agree that in the absence of actual expense data, it is prudent to estimate reasonable and probable cost data. However, Generally Accepted Accounting Principals do not cite operating expenses as a candidate for estimating. The candidates cited contain unknown factors normally determined outside the accounting system, such as uncollected receivables, salvage values, useful lives, and provisions for warranty. Operating expense is an historical element that should be known and accounted for as an actual with a high degree of accuracy. Estimating and recording operating expenses based on budget figures (obligations) cast uncertainty on a major element of financial reporting and render year-to-year comparisons unreliable.

Recommendations, Management Comments, and Evaluation Response

A. We recommend that the Commander, Defense Reutilization and Marketing Service, reimburse the Air Force and Navy for all sales of reimbursable B-52 aircraft and submarine material that Air Force and Navy Defense Business Operations Fund organizations turned in.

Management Comments. The DLA nonconcurred and stated there is no statutory authority to reimburse proceeds for scrap turned in, when the scrap came from equipment originally purchased with appropriated funds. Further, DLA stated that DRMS followed DoD Manual 4160.21-M, "Defense Reutilization and Marketing Manual," March 1990, in processing the turn in documents. The Manual requires the organization generating the property to annotate the turn-in document with a request for reimbursement of proceeds from the sale of the property. Neither the B-52 aircraft nor the submarine material turn-ins had annotations for reimbursement.

Evaluation Response. The DLA comments are nonresponsive. We agree that industrial fund customers generating property to DRMS for sales must annotate the turn-in document to certify their entitlement for reimbursement. However, DRMS reimbursed the Navy for the sales of submarine material in August 1995 without the annotation on the turn-in document. Specifically, after review of DoD Instruction 7310.1, "Disposition of Proceeds from DoD Sales of Surplus Personal Property," July 1993, on August 21, 1995, DLA directed DRMS to reimburse the Navy 100 percent of the proceeds from the sale of submarine material. Further, DLA advised DRMS that ". . . proposed departures from *long-standing practice* [emphasis added] must be supported by a business case." The Air Force was unaware of the DLA ruling; therefore, it should be entitled to the same reimbursement considerations as the Navy.

Statutory authority also exists for the credit of sales proceeds to DoD appropriations from the sales of appropriated equipment. United States Code, title 10, section 2210 (a), provides for the DoD appropriation to be credited the proceeds from the sale of appropriated material. Section 2210 (a) of title 10 states:

> Current applicable appropriations of the Department of Defense may be credited with proceeds of the disposals of supplies that are not financed by stock funds established under section 2208 of this title.

Applying the criteria of United States Code, title 10, section 2210 (a), and considering the 1995 DRMS reimbursement to the Navy, we still recommend that the Air Force and Navy be reimbursed the proceeds from the sale of the B-52 aircraft and submarine material respectively.

We request that DLA reconsider its position and provide additional comments on the final report. In addition, completion dates for actions planned should also accompany the comments.

Finding B. Controls Over Expedited Processing

The DRMS did not always provide the necessary screening time for the reutilization, transfer, and donation of expedited property during FY 1995, as required by Federal Property Management Regulation. DRMS workers were not consistently ensuring property was authorized expedited processing before initiating expedited processing. The necessary screening time was not provided because the existing manual process for determining expedited processing required the validation of numerous General Services Administration (GSA) approval waivers on an item-by-item basis in determining expedited authorization, which DRMS workers did not consistently adhere to--the type of problems that could be avoided by using the DRMS Automated Information System to make expedited processing decisions. Overall, we attributed the condition to the lack of management controls to ensure an adequate reconciliation between property and approval waivers authorizing expedited processing. As a result, approximately $2 billion in property did not receive 42 days of formal screening, as required by Federal Property Management Regulation H-68, which limited the reutilization, transfer, and donation of property and resulted in a significant reduction in the usual reutilization rates.

Background

Formal Screening Process. The Federal Property Management Regulation, along with GSA and DRMS implementing guidance requires the screening of all usable property for reutilization, transfer, and donation before its sale or disposal. As required in Federal Property Management Regulation H-68, "Utilization and Disposal," July 20, 1994, the formal screening of property for reutilization, transfer, and donation must take place for a minimum of 42 days. During FY 1995, DRMS processed $11.8 billion in property using the formal 42-day screening process. Other than formal screening, DRMS also processes property for expedited screening. During FY 1995, DRMS processed $6.7 billion in property using expedited screening.

Expedited Screening Process. Individual DRMOs can request authorization from GSA for the expedited screening of excess property when localized conditions warrant the need. For example, large generations of obsolete supplies or equipment with no reutilization potential and space constraints at a DRMO are reasons for requesting expedited screening. To request approval for expedited processing, individual DRMOs request a waiver from the local GSA Area Utilization Officer. The request is then passed to the GSA Regional Headquarters where a final decision is made. Items approved for expedited processing are approved for a specific period of time with an expiration date on each request. Approved waivers are used by DRMO workers as the basis to authorize expedited processing. Only property that has been validated on an

item-by-item basis by an approved GSA waiver is authorized expedited processing. To initiate expedited processing, DRMO workers must first physically validate that the item has an approved GSA waiver, then enter the item's national stock number into the DRMS Automated Information System with a materiel screening code (MSC) X. That results in the item passing directly to sales avoiding the full 42-day formal screening cycle. As a result, MSC X property is afforded only limited local screening during the accumulation period and then passed direct to sales.

Single Cycle Processing. In FY 1991, the DRMS implemented new procedures for the screening and sale of excess property, single cycle processing. The intended purpose of single cycle processing was to help individual DRMOs more efficiently process backlogs as a result of DoD downsizing and to enable sales preparation to occur simultaneously with the reutilization process. By using single cycle processing, a more efficient reutilization, transfer, donation, and sales process was envisioned for DRMS customers. Under single cycle processing the screening of excess property is divided into two major time periods followed by a final period in which the property is either disposed or sold.

o Period I is an accumulation period of 7 to 28 days, in which excess property is received at a DRMO and is grouped and identified for reutilization screening. That represents the screening period afforded MSC X property under expedited processing. At the conclusion of period I, MSC X property is passed directly to sales.

o Period II is a formal screening period of 42 days, during which DoD and other Federal agencies concurrently screen excess property for reutilization. Included within period II is a 21-day period for donation screening.

o Period III is a finalization period in which property is sold or removed.

Benefits of Property Reutilization, Transfer, Donation, and Sale. Property reutilized by DRMS customers saved DoD $2.3 billion in FY 1995 by eliminating unnecessary procurements; while the sale of DRMS property resulted in public sales of $302.3 million. Property not reutilized, transferred, or donated is offered for sale to the public on a competitive basis. Proceeds obtained from the sale of DRMS property are small in comparison to the original acquisition cost. For example, DRMS reported public sales of $302.3 million or 3.3 percent of the acquisition cost, on $9 billion of usable property sold in FY 1995. That represents an approximate $0.03 return on the acquisition dollar. In contrast, every dollar reutilized saves a dollar through the elimination of unnecessary procurements.

Controls Over Expedited Processing

Expedited Processing During FY 1995. During FY 1995, DRMS processed expeditiously $2 billion in property that was not authorized by GSA. The DRMS received personal property for formal or expedited screening with an aggregate acquisition value of $18.5 billion. Of the $6.7 billion in property that DRMS processed expeditiously, $2 billion was not authorized by GSA. The expedited property received limited visibility at the local DRMO through visual inspection during the accumulation period. The constrained screening period and limited visibility afforded this property, prevented its maximum reutilization. DRMS actions constitute noncompliance with Federal Property Management Regulation H-68. The regulation requires the formal screening of DRMS property for 42 days after the accumulation period unless a waiver from GSA is obtained.

Our analysis of the disposition of the approximate $2 billion in property that DRMS processed, using unauthorized expedited processing procedures, showed that the reutilization rate was 12.6 percent. That rate was lower than the DRMS overall FY 1995 reutilization rate of 28 percent. Table 3 summarizes the disposition of the $2 billion in property.

Table 3. Disposition Summary of Property Using Unauthorized Expeditious Processing

Disposition	Acquisition Value
Sold as usable	$1,029,423,876
Reutilized[1]	215,853,781
Downgraded to scrap	299,331,349
Demilitarized	290,680,301
Disposed	15,237,060
Awaiting disposition[2]	158,608,757
Total	**$2,009,135,124**

[1]Includes reutilization, transfer, and donation.
[2]Indicates property received in FY 1995 that was in DRMS inventory still awaiting disposition as of January 31, 1996.

Visibility of Expedited Property. Full visibility for maximum reutilization, transfer, and donation was not provided for expedited property. For instance, State regional representatives in attendance at the February 1996 State Agency for Surplus Property Convention stated that they use the GSA Federal Disposal System to electronically screen federal property. However, DoD expedited property (coded as MSC X) information does not flow from the DRMS Automated Information System to the GSA Federal Disposal System. DRMS managers stated that the Interrogation Requirement Information System, an on line computer system managed by DRMS, provides an alternative way for Federal and State screeners to electronically screen MSC X property, but for a limited period of time. State screeners, however, were not decisively using the DRMS Interrogation Requirement Information System. Only 1 of the 150 State

representatives in attendance at the convention expressed any knowledge of the Interrogation Requirement Information System. DRMS managers claimed the State representatives were briefed at previous conventions and were aware of the Interrogation Requirement Information System. In addition, DRMS managers claimed that four of the nine GSA regions had certified users. It appears State screeners did not decisively use the Interrogation Requirement Information System during FY 1995 for reasons beyond the scope of this evaluation. Because screening of $6.7 billion in expedited property primarily was done locally with little advertising, it appears the full reutilization, transfer, and donation benefit was not afforded expedited property during FY 1995.

Review of Expedited Screening at DRMOs. We attributed the unauthorized use of expedited processing to lack of adequate management controls over the DRMS manual decision process used for making expedited processing decisions. At three of the eight DRMOs reviewed, we judgmentally selected a sample of 59 items processed under expedited procedures, and found that 63 percent of the property was not authorized expedited processing by approved sources. Similarly, at five other DRMOs, property had been processed that was not authorized expedited processing The property was improperly processed because there was no adequate reconciliation between property and approval waivers authorizing expedited processing. Further, decisions to expeditiously process material are unduly complicated by the manual validation of GSA approval waivers to DRMS property before establishing authorization. As a result, at three of those five DRMOs we observed workers making expedited processing decisions without first determining whether the property was approved for expedited processing.

Property was processed without approval because the manual procedures for making expedited processing decisions were too burdensome, that is, too time-consuming and labor intensive for the DRMO workers to follow; the type of problems that could be avoided by using an automated decision process. The expedited processing problems we identified were avoidable had DRMS modified the DRMS Headquarters Automated Information System to only allow MSC X processing by the DRMOs for those national stock numbers approved by GSA. The DRMS Headquarters Automated Information System could be modified to send a code to the DRMOs Automated Information System authorizing expedited processing for approved national stock numbers. If that occurred, then MSC X assignment would no longer require DRMS workers to manually review GSA waivers before making expedited processing decisions. Expedited processing decisions would occur automatically under program control when DRMO workers input national stock numbers into the DRMS Automated Information System. The system would inform the DRMO that the property had an approved GSA waiver.

Management Comments on the Finding and Evaluation Response

The DLA partially concurred with the finding and agreed that better management controls over the expedited processing of DRMS property are necessary. However, DLA stated that GSA caused part of the unauthorized expedited processing of DRMS property by authorizing excess property to go direct to sale; thereby, bypassing the formal reutilization screening cycle.

Evaluation Response. We discussed with GSA its management authorizations of excess property for expedited processing. GSA stated that only 2 of 11 regions allowed property to move directly to sale for a limited number of times during FY 1995. Additionally, the authorization of excess property for expedited processing was not GSA policy nationwide, but accomplished only in special instances. Accordingly, the impact of the GSA authorization on the $2 billion in property that was not authorized expedited processing in FY 1995 was minimal.

Recommendations, Management Comments, and Evaluation Response

B. We recommend that the Commander, Defense Reutilization and Marketing Service:

1. Establish controls to ensure that all uses of the expedited processing of property is authorized by the General Services Administration.

Management Comments. The DLA partially concurred and agreed that better management controls over expedited processing are needed. In coordination with GSA, DLA issued new policy guidance to DRMS for immediate implementation that is designed to provide adequate controls over the expedited processing of DRMS property. In addition, the new policy guidance will be included in the revised DoD 4160.21-M, "Defense Reutilization and Marketing Manual."

Evaluation Response. The DLA comments are responsive. The additional controls that DLA established should help ensure that only authorized property is processed for expedited processing.

2. Automate the manual decision process for expedited processing by placing materiel screening code X assignment under the program control of the Defense Reutilization and Marketing Service Headquarters for the Automated Information System.

Management Comments. The DLA partially concurred. It stated that a systems change request has been initiated that when implemented will provide a separate management code for the DRMS Automated Information System to use in assigning expedited processing for DRMS property. The estimated completion date is October 1996.

Evaluation Response. The DLA planned actions are partially responsive to the intent of the recommendation. Assignment of a separate code to authorize expedited processing should improve control of expedited processing. However, DLA did not address who assigns the code, or how the code will be implemented. Both actions are key to the intent of the recommendation. For example, if DLA assigns a new code and it is applied in the field, then the DRMO workers will still be burdened with validating approval waivers on each item they process. However, by assigning the code on an item-by-item basis at DRMS Headquarters and pushing that code to the field DRMOs, managers at DRMS Headquarters would centrally control and validate approval waivers thereby eliminating the need for DRMO workers to validate approval waivers. Moreover, DRMS Headquarters, on a periodic basis, could reconcile the approval waivers with GSA to ensure that the waivers are up to date.

We request that DLA, in response to the final report, provide a method for expedited processing that will eliminate the need for local DRMOs to assign expedited processing codes and validate GSA approval waivers.

Finding C. Visibility of Serviceable Property for Reutilization

The DRMS had not provided front end screening (FES) notifications to the inventory control points (ICPs) for about $1.3 billion (acquisition value) of serviceable property. In addition, DRMS denied item managers' requests for serviceable property when property was available for redistribution. Consistent FES notifications had not been provided because the DRMS Automated Information System did not issue FES notifications to ICPs for expedited property, as required by DoD guidance. DRMS also denied item managers' requests for serviceable property because the Defense Logistics Agency Internal Review Office did not perform periodic reviews of DRMS denials of material requests. As a result, ICPs were buying new property at the same time DRMS had serviceable property readily available for reutilization that would offset or satisfy those property requirements.

Background

Inventory Control Point. The primary function of an ICP is to maintain operational readiness and supply availability while minimizing the investment in inventory. This is accomplished by forecasting future requirements, screening for excess items at the DRMS, and determining how much material to purchase. Item managers reduce their procurements through reutilization of serviceable (A1, A2, A4, A5, F7, and F8 condition) property. The FES notification alerts item managers that serviceable property is available at a DRMO. Without the FES notification, item managers must rely on other means, such as telephone calls, to determine the availability of serviceable property.

ICP Visibility of Serviceable Property

FES Notifications Critical to ICPs for Reutilization Decisions. Serviceable property with a DRMS assigned MSC X code (expedited property) was not provided to ICPs for reutilization decision through the FES notification program, as required by DoD Manual 4160.21-M, "Defense Reutilization and Marketing Manual," March 1990. DoD Manual 4160.21-M provides policy and procedures for reutilization and marketing of property. To ensure maximum reutilization, the Manual states that FES notification to the ICPs is required for all serviceable property. This did not occur for expedited property because the DRMS Automated Information System did not recognize MSC X as

a valid entry code for the automated generation of the FES notification. As a result, ICPs were not afforded appropriate reutilization visibility of approximately $1.3 billion (acquisition value) in serviceable property DRMS processed by expedited screening procedures during FY 1995.

The item managers at our sample ICP, Defense Supply Center, Richmond, believed that the FES notifications they received included all DRMS serviceable property. Therefore, the item managers did not consistently search other systems, such as the DRMS Interrogation Requirement Information System, for serviceable property before making procurements. As a result, the ICP was initiating new procurements while DRMS had serviceable property available for redistribution that would offset or fully satisfy those new property requirements.

We used a listing of about 9,000 items, coded MSC X by DRMS, but managed by the Defense Supply Center, Richmond, to determine whether the ICP was initiating new procurements while serviceable property was available at DRMS. During a 3-day period at the ICP, we identified 132 coded items available at DRMS, valued at $237,473, for which the ICP was initiating new procurements. Those items could have been used to offset or satisfy the planned purchases. Item managers informed us that they contacted DRMS on many of the items but were given a denial of redistribution request. We were able to document five denials for the items under review, as shown in the following example.

The DRMS denied a redistribution request for aircraft roller assembly (national stock number 1560-00-765-2400) with a unit price of $9.72. On December 30, 1994, the DRMO received 1,801 units in serviceable condition. The property was entered into the DRMS inventory on January 11, 1995. On February 1, 1995, requirements for the item breached the reorder point. The item manager developed a buy computation and determined a procurement was needed for 948 units at a total cost of $9,215. On February 15, 1995, the item manager called DRMS Headquarters to determine the items availability. DRMS Headquarters denied the item manager's request for the property. On March 9, 1995, DRMS referred the property for sale. One week later, DRMS assigned the property for auction. On July 7, 1995, DRMS sold 1,801 units at auction for $1,093. The expenditure of $8,640* could have been avoided.

We attributed the denials, in part, to lack of management oversight of the denial process. Specifically, the DLA Internal Review Office did not perform a periodic evaluation of the validity of material request denials. Also, by having the automated generation of FES notifications, it will be difficult for DRMS to deny the availability of the property for redistribution.

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*We calculated the $8,640 expenditure as follows. The item manager purchased 948 aircraft roller assemblies at a unit price of $9.72. The DRMS received, processed and sold 1,801 aircraft roller assemblies for $0.607 each. The difference in the unit price the item manager paid and the proceeds per unit that DRMS received was $9.113 per unit. The difference of $9.113 multiplied by the 948 units, represented the $8,640 net expenditure that was avoidable had DRMS issued the aircraft roller assemblies to the item manager.

Management Comments on the Finding and Evaluation Response

The DLA partially concurred with the finding. DLA agreed that FES notices were not produced as required. However, DLA stated that FES notices are not required for all serviceable property.

Evaluation Response. We agree with the DLA comments. During the evaluation, we used the correct criteria for FES notices as referenced in DoD Manual 4160.21-M, in data gathering and evaluating.

Recommendations, Management Comments, and Evaluation Response

C.1. We recommend that the Commander, Defense Reutilization and Marketing Service, implement a systems change request for its Automated Information System to provide a front-end screening notification to inventory control points for material screening code X property, as required by DoD Manual 4160.21-M.

Management Comments. The DLA concurred and stated that on April 2, 1996, DRMS implemented a systems change request that resulted in the DRMS Automated Information System producing the required FES notifications.

C.2. We recommend that the Director, Defense Logistics Agency, direct the Defense Logistics Agency Internal Review Office to periodically evaluate the Defense Reutilization and Marketing Service's denials of inventory control point material requests.

Management Comments. The DLA concurred and stated that it believed the five examples in our report of DRMS denials did not constitute a systems problem. However, it will conduct a thorough review to determine the extent of the problem, and take appropriate action. The estimated completion date is September 1997.

Part II - Additional Information

Appendix A. Profitability Projections

In an October 27, 1995, memorandum, "Defense Logistics Agency Privatization Initiatives," the Director, DLA, informed the Deputy Under Secretary of Defense (Logistics) that DRMS had made remarkable progress toward becoming a profitable enterprise.

> . . . The end result has been to take DRMS from a $140 million operating loss in FY 1992, to producing $26 million more in revenues than expenses in FY 1995.

In Finding A of this evaluation, we discuss our review of $74.3 million (25 percent) of DRMS total FY 1995 public sales revenue. Of that amount $28.2 million was overstated. We believe the actual DRMS profitability--if any--from FY 1992 through FY 1995 was difficult to quantify because the financial data DRMS presented had been consistently unreliable for assessing the results of operation. The unreliability was due in large part to the limitations of DoD and DRMS accounting systems established for recording and reporting DRMS financial data.

During the first 5 months of FY 1996, DRMS financial statements showed a $58 million operating loss. However, DRMS financial plans predict a profit of $297 million in FY 1996. The DRMS profitability projection for FY 1996 appears too optimistic given its current operating loss. DRMS financial plans predict an accumulated profit of $2.4 billion for the period FY 1996 through FY 2001. This projection also appears too optimistic based on current levels of operations, DBOF sales projections, and projected personnel expenses.

Future DRMS profitability is based largely on making more revenue than required to pay operating expenses. The DRMS used Military Department billings to pay for FY 1992 through FY 1995 operating losses. In FY 1996, DRMS expects to pay all operating expenses from public sales, and will no longer bill the Military Departments. The absence of supplemental funds will make any future operating losses more difficult to overcome, because DRMS would then need to generate additional revenue to offset the losses.

DBOF Sales Projections. We believe that three main factors determine DRMS DBOF sales. The factors provide good indicators of DRMS future profitability.

- o Property turned in by DoD
- o Return on asset sales
- o Reutilization, transfer, and donation activity

Property Turned in by DoD. Property turned in by DoD depots is projected to decrease in the future resulting in less inventory available for DRMS reutilization, transfer, donation, and sales. The combined impact of major DoD downsizing efforts, such as large inventory reductions; drawdown of forces; and base closures, resulted in an abnormally high level of DRMS

activity in past years that will not continue in the future. For example, from FY 1992 through FY 1995, DoD depots turned in $21 billion in secondary items to DRMS. However, from FY 1996 through FY 1999, DoD depots are projected to turn in only $9 billion in property to DRMS. Moreover, for FY 2000 and FY 2001, DRMS is projected to receive from turn in only $2 billion. Therefore, with a decreasing level of future inventory, DRMS must obtain more proceeds from future sales to pay for overhead and still generate a profit. DRMS plans to obtain more proceeds in the future by improving its return on asset sales. The return on asset sales is a DRMS performance measure that is calculated by dividing the depreciated acquisition value* of usable property sold into the total DBOF proceeds received from the sale.

Return on Asset Sales. Low first quarter return on asset sales performance will make it difficult for DRMS to obtain its planned return on asset sales goal for FY 1996. DRMS primary source of increasing revenue is a higher future return on asset sales than was obtained in the past years. The DRMS planned goal for return on asset sales for FY 1996 is 6 percent verses the actual return of 4.3 percent in FY 1995, and 2.8 percent in FY 1994. Given the past returns on asset sales and the fact that the first quarter of FY 1996 was 1.3 percent, it is highly unlikely that a 6 percent return on asset sales will be realized in FY 1996. To help improve its return on asset sales DRMS hired auctioneering firms in FY 1995.

Early results of contracting out the auctioneering of DRMS property has not resulted in the DRMS expected higher return on asset sales performance. One of the DRMS hybrid privatization efforts is the use of auctioneering firms to conduct auctions of DRMS inventory. By using professional auctioneers and their contacts to reach a broader customer base, DRMS management expects that more items will be sold and a higher return will be realized. Historically, the average DRMS return on asset sales has been 2.4 percent. Beginning in FY 1995, DRMS awarded auctioneering contracts to five firms. As of March 1996, one firm conducted auctions at five locations and two firms have accepted a property list for auction. The acquisition value of items sold during the five auctions was $78.9 million and the net proceeds were $1.3 million for a return on asset sales of 1.66 percent. The cost of the auctioneer was $154,000. The return on asset sales DRMS received from the auctions was less than what it achieved in previous fiscal years (average of 2.4 percent), using in-house DRMO auctioneers, and at an additional cost of $154,000. While it is too early to determine whether the long range impact of using private auctioneering services will be favorable, the performance obtained to date indicates that a 6 percent return on asset sales will not be readily achieved.

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*The depreciated acquisition value of usable property sold, is based on two DRMS assumptions. First, DRMS assumes that 60 percent of the property it processes in any fiscal year is new, while 40 percent is used (the assumption is based on historical averages). Second, DRMS multiplies those percentages by the aggregate acquisition value of usable items sold. The product is then depreciated to 90 percent of the original acquisition value for new property, and to 30 percent for used property. The result is the depreciated acquisition value of usable property sold.

Reutilization, Transfer, and Donation Activity. The DRMS increased its reutilization, transfer, and donation goal in FY 1996. The increase will result in less property available for public sales in FY 1996, further reducing DRMS future profitability. For FY 1996, DRMS planned an increase in its primary mission of reutilization, transfer, and donation (goal of 32 percent in FY 1996 versus actual of 28 percent in FY 1995). The increase will result in less planned inventory available for DBOF sales than in the past. Therefore, with a planned increase in reutilization; transfer; and donation, the trend of DBOF sales should be decreasing and not increasing.

Overall Sales Projections. The three factors we analyzed by using DRMS financial plans show that DRMS may fall substantially short of its sales objective from FY 1996 through FY 2001. Other factors, as discussed below, will also affect DRMS profitability.

Current FY 1996 Profitability Performance. Lower than expected first quarter FY 1996 profitability performance will make it more difficult for DRMS to achieve a profit in FY 1996. As of the end of February 1996, DRMS financial statements showed a net operating loss of approximately $58 million. At the same period in FY 1995, DRMS showed an approximate break even position (revenue was $131.2 million and expenses were $130.9 million). During the same period in FY 1994, DRMS presented a net operating loss of $18 million. Although DRMS sales revenue historically has been low for the first half of each year, FY 1996 performance as of March 1996 was significantly lower than that of FYs 1994 and 1995. In addition, expenses were projected to be $17 million higher in FY 1996 than in FY 1995. That will further burden DRMS to make a profit in FY 1996.

Unprojected Sales Reimbursements. Unplanned financial reimbursements to the Army will further burden DRMS in making a profit in FY 1996 and FY 1997. As reported in the Inspector General, DoD, draft audit report "Disposition of Excess Army Helicopters and Flight-Safety-Critical Helicopter Parts (Project No. 5FJ-5024)," March 20 1996, DRMS did not reimburse the Army for the sale of a helicopter because the Army did not file a claim for reimbursement of funds from the sale of the helicopter. We recommended that the Army file a claim with the Under Secretary of Defense (Comptroller). The Army projects to store or sell 500 more helicopters and associated helicopter engines during FY 1996 and FY 1997. As a result, we estimate DRMS must reimburse the Army approximately $70 million in revenue proceeds during FY 1996 and FY 1997. This reimbursement will further reduce the DRMS future profitability.

Expense Projections. The DRMS financial plan costs for personnel are understated by $228 million because planned reductions did not occur. The increase in personnel costs during FY 1996 through FY 2001 will further encumber DRMS in making future profits. The largest variable expense in the DRMS operation is personnel. DRMS conducted a study (Impact of Readiness Study) and projected a decrease of 498 personnel during FY 1995. However, the planned reductions were never carried out, and personnel reductions totaled only 118 for FY 1995. In prior years, DRMS was not subjected to DLA personnel reductions because DRMS work load was increasing and DLA was

able to meet personnel reduction goals of 4 percent per year mandated by DoD through personnel reductions in the depots. Beginning in FY 1995, DRMS was subjected to the DLA planned personnel reductions and targeted for a 4-percent reduction in personnel each year in its program objective memorandum. Because DRMS had frontloaded a 13-percent reduction in personnel in FY 1995 that was not achieved, and the DLA 4-percent reduction each year was not considered in the DRMS financial plan; the net result of the two factors in the DRMS plans is $228 million more in personnel costs than planned.

Summary. The DRMS can no longer rely on Military Department billings to fund future operating losses. As a result, future DRMS profitability is based principally on generating sufficient revenue to exceed its cost of operations and to keep constant or lower its expenses. We believe that task may be difficult for DRMS. Future declining turn-ins of property from DoD depots, unplanned large dollar value paybacks to reimbursable customers, rising FY 1996 expenses, lower than expected FY 1996 return on asset sales, and mid-year 1996 performance suggest a more realistic view of DRMS future profitability.

Appendix B. Scope and Methodology

Scope and Methodology

Evaluation Approach. Our evaluation scope included a limited review of financial data, and we assessed several aspects of the DRMS reutilization program.

Financial Data. We limited our review of DRMS financial data to public sales and operating expenses. To assess the accuracy of reported public sales revenues and operating expenses for FY 1995, we analyzed financial transactions made at DRMS Headquarters, the International Sales Office and eight DRMOs: Alameda, California; Columbus, Ohio; Fort Lewis, Washington; Mechanicsburg, Pennsylvania; Ogden, Utah; Stockton, California; Tooele, Utah; and Tucson, Arizona. The eight DRMOs we selected for review were among those that had the largest public sales in the United States for FY 1995. We analyzed the DRMS Headquarters financial adjustments and reviewed sales transactions at the International Sales Office and sales and expense transactions at the eight DRMOs. We verified the amount of public sales revenue entered daily in the DRMS DBOF account (and in turn, monthly to DFAS). We traced daily amounts entered into the DRMS DBOF account to sales and contract source documentation, DD Form 1131 (collection vouchers), DD Form 1049 (voucher for refunds), and DD Form 1080/1081 (transfers between appropriations). We questioned DRMS and DFAS-Columbus officials about improvements made to accounting systems since our review of DRMS FY 1994 financial data. In the case of DBOF activity turn-ins, we also questioned DLA and DRMS officials on the propriety of retaining sales proceeds.

Reutilization Program. We reviewed the procedures DRMS used for expedited processing of inventory. We visited the Defense Supply Center, Richmond, an ICP, to assess the effect of expedited processing on property procurements. At the ICP we reviewed a judgmental sample of 9,000 items managed by the ICP that were processed by DRMS with expedited methods during FY 1995. We also reviewed 132 items at the ICP to determine the effect of DRMS property denials. We attended the National Association of State Agencies for Surplus Property mid-winter convention, to learn about the effects of expedited screening on the State screeners. We selected 8 of the top 10 DRMOs in sales revenue during FY 1995 for a review of reutilization processing. For the 8 DRMOs selected, we:

o reviewed and observed FY 1995 inventory that was processed using expedited procedures,

o performed tests on expedited property to determine whether it was authorized for expedited processing, and

o interviewed personnel from the DRMOs.

Use of Computer-Processed Data. The DRMS could not provide us with an accurate listing of property that was processed using expedited screening procedures from its Defense Automated Information System. Therefore, we analyzed data obtained from the Interrogation Disposal Management System that DRMS reported. The data showed that for FY 1995, DRMS processed property with an acquisition value of $6.7 billion using expedited screening procedures. We performed limited tests on the reliability of computer-processed data DRMS provided to us in the Interrogation Disposal Management System format. To the extent that we reviewed the computer-processed data, we concluded that it was sufficiently reliable to be used in meeting our evaluation objectives.

Evaluation Period and Locations. We performed this evaluation from November 1995 through March 1996. Appendix E lists the organizations we visited or contacted.

Appendix C. Summary of Prior Audits and Other Reports

General Accounting Office

General Accounting Office (GAO) Report No. NSIAD-94-40 (OSD Case No. 9522), "Widespread Abuse in Recycling Program Increases Funds for Recreational Activities," December 1994, stated that millions of dollars were being used annually for Moral Welfare and Recreation activities that should be used instead to offset the need for appropriated funds or be returned to the U.S. Treasury. That occurred because military bases were routinely receiving money from the sale of aircraft, vehicles, and other materials that DoD policy specifically excluded from the recycling program and then were using the proceeds to fund Moral Welfare and Recreation activities. In addition, some installations, without proper authorization, were holding their own sales rather than selling materials through DRMOs. The report recommended that the Secretary of Defense require that internal controls be complied with to ensure that installations and DRMOs meet the letter and intent of the 1982 legislation and follow existing DoD policy. The Deputy Under Secretary of Defense (Environmental Security) generally concurred with the GAO recommendations.

GAO Report No. NSIAD-94-189 (OSD Case No. 9733), "Opportunities Exist to Enhance DoD's Sales of Surplus Aircraft Parts," September 1994, stated that DoD proceeds from the sale of commercially-salable surplus aircraft parts averaged less than 1 percent of the price DoD paid for the parts. The report stated that DoD did not mutilate or destroy many flight-safety-critical parts that were sold as scrap, and did not require buyers to warrant or certify that all scrap parts purchased would be used only as scrap. The report recommended that the Secretary of Defense provide greater financial incentives to enhance the proceeds from sales of usable aircraft parts, and direct DLA and the Military Departments to identify commercially-salable aircraft parts and maintain documentation that would be adequate for certification by the Federal Aviation Administration. The Deputy Under Secretary of Defense (Logistics) concurred with the GAO recommendations.

Inspector General

Inspector General (IG), DoD, Report No. 95-025, "Distribution of Proceeds From the Sale of Reimbursable Scrap Material," November 8, 1994, reported that DRMS did not adequately control the distribution of proceeds from the sale of scrap materiel that qualified for reimbursement, and expenses related to the sale and processing of the scrap materiel were not recovered before distribution of the proceeds to qualified DoD recipients. As a result, recycling programs at

installations were receiving proceeds that should have been distributed to DBOF organizations to reduce operating expenses. Additionally, $8.5 million of FY 1993 expenses incurred for processing reimbursable scrap was not recovered before the distribution of proceeds. The report recommended that DRMS stop distributing to installation recycling programs the proceeds DBOF organizations turned in from the sale of scrap; recover the operating expenses incurred in processing reimbursable scrap; and require that audit trails be created for reimbursements. DRMS Management generally concurred with the recommendations. However, the Under Secretary of Defense (Comptroller) did not implement a method of recovering operating expenses.

During the last 5 years, multiple audits have been performed relating to the Chief Financial Officers Act and financial statements of DBOF business area. The principle audits relating to the DLA business areas of DBOF are summarized below.

IG, DoD, Report No, 95-220, "Financial Statements of the Defense Logistics Agency Reutilization and Marketing Service Business Area of the Defense Business Operations Fund for FY 1994," June 5, 1995, stated that the account balances presented in the Statement of Financial Position and Statement of Operations were based on unreliable data. The report disclaimed an opinion on the financial statements and identified internal control weaknesses that were considered material under standards established by Office of Management and Budget Bulletin 93-06. The report recommended that the Under Secretary of Defense (Comptroller) suspend the DRMS FY 1995 budget authority, and reconvene the DRMS Unit Cost Working Group to develop a fee structure for DRMS services. The report recommended that DLA transfer all accounting responsibilities and related resources for national sales from the International Sales Office to the DFAS, make the necessary changes to account for the hazardous program on an accrual basis, and establish relevant performance measures for the DRMS. The report recommended that DRMS establish procedures that require reconciliations to DFAS records; implement controls over accounts receivable and accounts payable; establish accrual accounting procedures for reporting revenues and expenses; include in future annual assurance reports, the material weaknesses in the areas of financial statement presentation, operating system interface problems, and inventory controls; and include in the inventory of assessable units the major DRMS functions related to the preparation of financial statements.

The DLA agreed to establish the necessary controls and procedures to ensure that the reported financial information more accurately reflects the operations of DRMS. However, DLA stated that performance measures for DRMS should not be developed by disposal program. Two recommendations went through mediation favorably. In the first, DLA agreed to develop more meaningful performance measures for the DRMS that show revenues and expenses by disposal program, and to make sure that the performance measures are consistent with revenues and expenses reported in the Statement of Operations. In the second, DLA agreed to reconvene the DRMS Unit Cost Working Group to evaluate a fee structure for the DRMS.

IG, DoD, Report No. 94-167, "Selected Financial Account of the Defense Logistics Agency Defense Business Operation Fund Financial Statements for FY 1993," June 30, 1994, summarized the results of several reports on the DLA DBOF accounts. The report provided an adverse opinion on the financial data examined, and identified internal control weaknesses that were considered material under standards established by Office of Management and Budget Bulletin 93-06. Audit trails were not adequate, reconciliations were not performed to support reported amounts, and transactions were not matched to the proper accounting period. Material instances of noncompliance with laws and regulations were addressed. Requirements of the Federal Managers Financial Integrity Act, the DoD Accounting Manual, and Office of Management and Budget and DoD guidance of the form and content of financial statements were not effectively implemented. The report contained no recommendations.

IG, DoD, Report No. 94-164, "Financial Statement of the Defense Reutilization and Marketing Service for FY 1993," June 30, 1994, stated that the FY 1993 financial statements for DRMS were not prepared in accordance with generally accepted accounting principles, and key asset, revenue, and expense accounts were not adequately supported or compiled in the financial records. As a result, the financial statements could not be relied on for assessing the DRMS financial position, results of operations, or performance. Also, the DRMS implementation of the DoD Internal Management Control Program was ineffective at reporting weaknesses related to the preparation of financial statements. As a result, internal control weaknesses affecting the ability of the DRMS to prepare financial statements were not corrected or reported to higher command levels. The report recommended that DRMS implement necessary accounting principles to report sales revenue and inventory in accordance with generally accepted accounting principles, implement fees for services, disclose information on sales, adapt existing cost accounting systems, report inventory at net-realizable value, and establish controls over accounts receivable and accounts payable including the identification of suspense account balances. The report recommended that the DLA transfer accounting functions from the International Sales Office to DFAS. The report recommended that the Comptroller, DoD, establish a fee structure for DRMS. DRMS generally concurred with the recommendations. However, DLA nonconcurred with the recommendation related to the transfer of accounting functions from the International Sales Office to DFAS. DRMS told the Comptroller, DoD, that it did not need a fee structure.

IG, DoD, Report No. 94-159, "Fund Balances with the Treasury Accounts on the FY 1993 Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund," June 30, 1994, stated that the fund balances of the DLA business area's fund balances with the Treasury accounts were not prepared in accordance with generally accepted accounting principles for Federal agencies. As a result, presentations related to the DLA cumulative $1.4 billion fund balance with the Treasury in its FY 1993 statements of financial position, cash flow, and related footnotes are misleading and cannot be relied on by users of the financial statements. The report recommended that guidance be suspended relating to fund balances with the Treasury because it was not in accordance with generally accepted accounting

principles; that procedures and controls be issued to establish adequate audit trails, reconciliations, and controls over appropriation limits; that sublimits be established for business areas; and that discrepancies be disclosed in the FY 1993 statement of cash flow and accompanying footnotes.

The DLA concurred with the recommendation to establish appropriate sublimits for business areas, and partially concurred with the recommendation to disclose discrepancies in the FY 1993 statements of cash flow and accompanying footnotes. The Under Secretary of Defense (Comptroller) issued guidance that returned responsibilities for cash management back to the DoD Components for FY 1995. Regarding DRMS, the report noted that $151.2 million in FY 1993 DRMS collections and dispersements relating to the sales of excess material at DRMS was deposited through deposit fund sales accounts (suspense) that were not monitored by the DRMS Appropriation Control and Reporting System.

IG, DoD, Report No. 94-158, "Cash Management Within the Defense Reutilization and Marketing Service," June 30, 1994, reported that the DFAS-Columbus retained pre-FY 1993 sales proceeds in suspense accounts for extended periods rather than releasing the proceeds to qualified recipients in a timely manner. As a result, the funds could not be used by the qualified recipients for operating expenses. The report recommended that DRMS immediately close pre-FY 1993 sales contracts and transfer the outstanding sales proceeds to the DRMS DBOF account. The report also recommended that the International Sales Office deposit all sales proceeds generated from sales of scrap material directly into the account of the qualified recipients. Additionally, the report recommended that DRMS review and release FY 1993 sales proceeds to qualified recipients. The DLA concurred with all recommendations, indicating that action would be taken to transfer all sales proceeds being retained in several suspense accounts maintained by DFAS-Columbus to the accounts of qualified recipients; to immediately deposit all future sales proceeds generated from the sales of scrap material into the accounts of qualified recipients; and to identify and transfer all sales proceeds being retained by local finance offices to the accounts of qualified recipients.

IG, DoD, Report No. 94-150, "Inventory Accounts on the Financial Statements of the Defense Logistics Agency Business Areas of the Defense Business Operations Fund for FY 1993," June 28, 1994, stated that general ledger accounts, nonfinancial records, and yearend accounting adjustments did not reflect the correct value of inventory under the control and management of DLA. As a result, the asset balances presented on the financial statements were misstated; were not properly classified; did not include all reportable inventories; and did not disclose all restrictions on the sale, use, or disposition of inventories and other nonfinancial resources. The report recommended that procedures and controls be established to ensure that general ledger accounts, nonfinancial records, and yearend accounting adjustments reflect the correct value of inventory under the control and management of DLA. It also recommended that physical records and documentation provide adequate support for inventory accounts, other than stock on hand, and that valuations, categorizations, and disclosures of financial statements be performed in accordance with Office of Management and Budget and DoD guidelines.

Additionally, the report recommended that a method be developed to value reutilization and disposal inventory held by wholesale supply organizations that accurately reflect the best estimate of net realizable value.

The DLA generally concurred with the valuation, categorization, and disclosure issues identified in the report but nonconcurred with revising a footnote to the financial statement. The Under Secretary of Defense (Comptroller), concurred with the recommendations concerning inventory counts, support for inventory accounts, other than stock on hand, and the recommendations concerning valuation and disclosure of DLA inventory accounts. Because the financial statements were already published at the time of the audit and because DLA was unwilling and unable to make the requested changes, we decided to close the issue.

Appendix D. Summary of Potential Benefits Resulting From Evaluation

Recommendation Reference	Description of Benefit	Amount and Type of Benefit
A.	Economy and Efficiency. Returns proceeds from the sales of reimbursable materials to the Military Department that turned in the material.	Funds put to better use. The Air Force and Navy should be reimbursed from DRMS (Appropriation 97X49305N54) $8.9 million to (Appropriation 97X4930NA1G) and $0.6 million, to (Appropriation 97X4930.FA206E), respectively.
B.1. and B.2	Management Controls, Economy and Efficiency. Provides required 42-day screening time avoiding unnecessary procurements.	Nonmonetary.
C.1. and C.2	Economy and Efficiency. Increases visibility of expedited processed items to ICPs.	Undeterminable.*

*Because we visited only one ICP in our limited review we cannot determine the full monetary benefit of total DRMS expedited property visibility to all ICPs. However, at the one ICP we visited, $237,473 in property procurements were avoidable had DRMS provided that ICP the required expedited property visibility through FES notification.

Appendix E. Organizations Visited or Contacted

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller), Washington, D.C.
Deputy Under Secretary of Defense Logistics, Washington, D.C.

Other Defense Organizations

Defense Logistics Agency, Ft. Belvior, VA
- Defense Reutilization and Marketing Service, Battle Creek, MI
  - International Sales Office, Memphis, TN
  - Defense Reutilization and Marketing Service, Region East, Columbus, OH
  - Defense Reutilization and Marketing Service, Region West, Ogden, UT
  - Defense Reutilization and Marketing Office, Alameda, CA
  - Defense Reutilization and Marketing Office, Columbus, OH
  - Defense Reutilization and Marketing Office, Lewis, WA
  - Defense Reutilization and Marketing Office, Mechanicsburg, PA
  - Defense Reutilization and Marketing Office, Memphis, Tenn
  - Defense Reutilization and Marketing Office, Ogden, UT
  - Defense Reutilization and Marketing Office, Stockton, CA
  - Defense Reutilization and Marketing Office, Tooele, UT
  - Defense Reutilization and Marketing Office, Tucson, AZ
- Defense Supply Center, Richmond, VA

Defense Finance and Accounting Service, Arlington, VA
- Defense Finance and Accounting Service Center, Columbus, OH

Non-Defense Federal Organizations

General Services Administration, Washington, D.C.

Appendix F. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Acquisition and Technology)
  Deputy Under Secretary of Defense (Logistics)
  Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Assistant to the Secretary of Defense (Public Affairs)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management)
Auditor General, Department of the Navy

Department of the Air Force

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

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
  Commander, Defense Reutilization and Marketing Service
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

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

Non-Defense Federal Organizations (cont'd)

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Defense Logistics Agency Comments

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

IN REPLY REFER TO DDAI

JUL 26 1996

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE

SUBJECT: Draft Audit Report, Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

This is in response to your May 22, 1996, subject draft report.

JACQUELINE G. BRYANT
Chief, Internal Review Office

Encl

Federal Recycling Program Printed on Recycled Paper

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Finding A. Sales Revenue and Operating Expense

The DRMS reported sales revenue and operating expense in its FY 1995 Statement Operations that were unreliable. The same accounting deficiencies that caused us to disclaim our opinion on DRMS FY 1994 financial statements were still prevalent in FY 1995.

- Sales revenue was not integrated with cash collection, accounts receivable, and inventory recordings in general ledger balances: instead sales revenue was accounted for separately and not reconciled with related general ledger balances.

- Interservice support operating expense was not recognized when incurred or validated by certification instead, it was estimated based on obligation rates and not adjusted to actual.

As a result, DRMS financial information reported for FY 1995 contained overstated revenue and expense and cannot be relied upon for assessing its results of operations. About $9.5 million of the overstated revenue resulted because DRMS did not reimburse the Air Force $8.9 million in proceeds from the sale of demilitarized B-52 aircraft material and related engines. Also, DRMS did not reimburse the Navy $0.6 million in proceeds for the sale of demilitarized submarine scrap.

DLA Comments:

Partially concur. Our specific comments to the many issues addressed in the finding are provided below.

ISSUE of RELIABILITY: We agree that the Defense Business Management System (DBMS) lacks the integrated capability to adequately account for all aspects of property disposal transactions. As such, the financial data contained in the DBMS accounting module was supplemented with additional financial data contained in the other systems. Although the many non-integrated systems do not reconcile to each other, the attempt to provide the most accurate data and reject the known inaccurate information should not be a criticism of DRMS.

ISSUE OF OVERSTATED REVENUE: We agree that most of the inaccuracies resulted from attempts to compensate for prior year omissions and understatements and to the transition from cash to accrual accounting. The accounting system (DBMS) lacks the true capability to adequately account for prior year transactions. To compensate for the lack of a true prior period adjustment general ledger account and supporting subsidiary ledger, amounts are recorded as current year transactions and then manual financial reporting adjustments are routinely made. When the financial statements were prepared, we were unaware of the transactions identified by the DoDIG. Additionally, for the unreimbursed proceeds, we disagree that DRMS revenue was

overstated by approximately $9.5 million. Our rationale is provided in our response to the recommendation.

ISSUE of EXPENSE OVERSTATEMENT: We disagree that estimating expenses to reflect reasonable and probable costs when actual expense data is not available is an incorrect application of Generally Accepted Accounting Principles. Accrual accounting dictates the recording of expenses when services are received regardless of the timing of the billing and disbursement. In this case, the reasonable and probable cost data are the obligations that are recorded based on costs documented on an Interservice Support Agreement.

Action Officer: Richard Sninsky, FOX
Review/Approval: J. D. McCarthy, CAPT, SC, USN, Comptroller
Coordination: [illegible], DDAT, 24 [illegible]

DLA Approval

[signature]

RAY T. McCOY
Major General, USA
Principal Deputy Director

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Recommendation A. We recommend that the Commander, Defense Reutilization and Marketing Service, reimburse the Air Force and Navy for all sales of reimbursable B-52 aircraft and submarine material that Air Force and Navy Defense Business Operations Fund organizations turned in.

DLA Comments: Nonconcur. Our position is that there is no statutory authority to reimburse proceeds for scrap turned-in, when that scrap came from equipment originally purchased with appropriated funds. Unless the Office of Under Secretary of Defense (Comptroller) advises to contrary, DRMS was correct in showing the unreimbursed proceeds as revenue. Additionally, DRMS followed existing regulatory guidance in processing the turn-in documents. DoD 4160.21-M requires the generating activity to annotate whether they are entitled to and expect reimbursement from the sale of the property. The turn-in documents for the cited property was not so annotated.

Disposition: Action is considered complete.

Action Officer: Richard Sninsky, FOX
Review/Approval: J. D. McCarthy, CAPT, SC, USN, Comptroller
Coordination: [illegible], DDAI, 24 Jul

DLA Approval

[illegible]
RAY E. McCOY
Major General, USA
Principal Deputy Director

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Finding B: Controls Over Expedited Processing.

The DRMS did not always provide the necessary screening time for the reutilization, transfer, and donation of expedited property during FY 1995, as required by Federal Property Management Regulation. DRMS workers were not consistently ensuring property was authorized expedited processing before initiating expedited processing. The necessary screening time was not provided because the existing manual process for determining expedited processing required the validation of numerous General Services Administration (GSA) approval waivers on an item by item basis in determining expedited authorization, which DRMS workers did not consistently adhere to the type of problems that could be avoided by using the DRMS Automated Information System to make expedited processing decisions. Overall, we attributed the condition to the lack of management controls to ensure an adequate reconciliation between property and approval waivers authorizing expedited processing. As a result, approximately $2 billion in property did not receive 42 days of formal screening, as required by Federal Property Management Regulation H-68, which limited the reutilization, transfer and donation of property and resulted in a significant reduction in the usual reutilization rates.

DLA Comments: Partially concur. We agree that better management controls are necessary. However, the approval criteria and consistency of application for use of Expedited Processing (EP) among the ten GSA Regional Offices makes it difficult to single out DRMS for criticism. For example, in some cases, GSA Regional Offices have authorized excess property to go "direct to sale," which is clearly inappropriate.

As background, the Federal Property Management Regulation Bulletin H-68, "Utilization and Disposal," dated July 20, 1994, was published by the GSA in response to negotiations with the Defense Logistics Agency in 1990 and 1991. Known as "single-cycle," its intent was to expedite the processing of excess personal property due to the impending DoD drawdown. Though successful, in some cases single-cycle did not go far enough and the practice of EP evolved due to the need to move excess property faster than was originally contemplated by single-cycle. The practice is based largely on reciprocal agreements and procedures developed between individual Defense Reutilization and Marketing Offices and GSA Regional Offices. Although this practice is widely recognized throughout GSA, it has never been codified in the FPMR.

On several occasions, DLA has suggested to GSA that the FPMR Bulletin H-68 should be revised, as it codifies into regulation many of DRMS' most basic processes and, therefore, precludes adjusting those processes to a rapidly changing environment. GSA has thus far refused to consider any changes and is preparing to reauthorize the bulletin beyond its current expiration date (July 31, 1996).

Action Officer: Thomas Ruckdaschel, MMLC, (703)767-1534, July 16, 1996
Review/Approval: Randle D. Bales, CAPT, SC, USN, (703)767-2600, July 22, 1996

DLA Approval:

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Recommendation B-1. We recommend that the Commander, Defense Reutilization and Marketing Service establish controls to ensure that all uses of the expedited processing of property is authorized by the General Services Administration.

DLA Comments: Partially concur. While GSA authorization is certainly a requirement, approval criteria among the ten GSA Regional Offices has been inconsistent. We agree, however, that better management controls are necessary. In coordination with GSA, we have issued the following policy guidance to DRMS for immediate implementation. General policy guidance has also been included in the revised (DRAFT) DoD 4160.21-M.

- On a case-by-case basis, and only after prior coordination with the GSA Area Utilization Officer and appropriate GSA Regional Office, Expedited Processing (EP) may be authorized where there is documented low reutilization/transfer/donation potential, excessive backlog situations, potential deterioration from outside storage or for other compelling reasons that impact the DRMOs ability to store the quantities of property being turned in.

- There must be a minimum amount of federal/donation screening and a clear delineation made between excess & surplus property while it undergoes EP. EP shall consist of a shortened accumulation period, a minimum of fifteen days' federal screening, and a minimum of fifteen days' donation screening. In such cases, the "Blue Light Special" [Period Five] will not apply.

- EP shall be considered a temporary measure meant to address specific issues on a site-by-site basis. Its duration will be based on individual circumstances.

- Processing excess property direct to sale is not authorized.

As a reminder, GSA does not have oversight of certain legislatively mandated programs (i.e. Regional Logistical Support Offices, Cambria County Equipment Center), therefore, DRMOs must carefully consider and be fully able to justify requests for EP. Close coordination with the R/T/D community is essential. We will continue to work with GSA on incorporating EP practices within the framework of the Federal Property Management Regulations.

Disposition: Action is considered complete.

Action Officer: Thomas Ruckdaschel, MMLC, (703)767-1534, July 16, 1996
Review/Approval: Randle D. Bales, CAPT, SC, USN, (703)767-2600, July 22, 1996
for, DDAI, 24 Jul

DLA Approval:

RAY E. McCOY
Major General, USA
Principal Deputy Director

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Recommendation B-2. Automate the manual decision process for expedited processing by placing materiel screening code X assignment under the program control of the Defense Reutilization and Marketing Service Headquarters for the Automated Information System.

DLA Comments: Partially Concur. A Systems Change Request (SCR) is in process to properly define those items undergoing expedited processing as opposed to those items being processed direct to sales. Establishing a new Material Screening Code for sole use of EP will place a control mechanism to identify any authorized items in expedited processing. The use of expediting screening will be validated by DRMS-S.

Disposition: Action is ongoing. Estimated Completion Date: October 1996

Action Officer: Thomas Ruckdaschel, MMLC, (703)767-1534, July 16, 1996
Review/Approval: Randle D. Bales, CAPT, SC, USN, (703)767-2600, July 22, 1996
, DDAT,
DLA Approval:

RAY E. McCOY
Major General, USA
Principal Deputy Director

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Finding C: Visibility of Serviceable Property for Reutilization.

The DRMS had not provided front end screening (FES) notifications to the inventory control points (ICPs) for about $1.3 billion (acquisition value) of serviceable property. In addition, DRMS denied item managers' requests for serviceable property when property was available for redistribution. Consistent FES notifications had not been provided because the DRMS Automated Information System did not issue FES notifications to ICPs for expedited property, as required by DoD guidance. DRMS also denied item managers' requests for serviceable property because the Defense Logistics Agency Internal Review Office did not perform periodic reviews of DRMS denials of material requests. As a result, ICPs were buying new property at the same time DRMS had serviceable property readily available for reutilization that would offset or satisfy those property requirements.

DLA Comments: Partially concur. As a result of a system deficiency in the DRMS Automated Information System (DAISY), FES notices were not produced as required. However, DoD 4160.21-M does not require FES notification for *all* serviceable property as inferred in the finding. Each Military Service has identified their own criteria for DAISY FES notices. DLA ICPs for example, require FES notices for property in condition codes A1 or A4 with a total dollar value of $50.00 or more. Further, FES notices are generated only for excess property with valid NSNs. We will revalidate FES requirements with each Military Service and DLA ICP.

Action Officer: Thomas Ruckdaschel, MMLC, (703)767-1534, July 16, 1996
Review/Approval: Randle D. Bales, CAPT, SC, USN, (703)767-2600, July 22, 1996
JCT, DDAI, 24 July
DLA Approval:

RAY E. McCOY
Major General, USA
Principal Deputy Director

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Recommendation C-1. We recommend that the Commander, Defense Reutilization and Marketing Service, implement a systems change request for its Automated Information System to provide a front end screening notification to inventory control points for material screening code X property, as required by DoD Manual 4160.21-M.

DLA Comments: Concur. On April 2, 1996, DRMS implemented a DAISY systems change to allow for automated generation of FES notices to the Inventory Control Points as well as the GSA FEDS system, thus providing full visibility of property processed under EP.

Disposition: Action is considered complete.

Action Officer: Thomas Ruckdaschel, MMLC, (703)767-1534, July 16, 1996
Review/Approval: Randle D. Bales, CAPT, SC, USN, (703)767-2600, July 22, 1996
DLA Approval: DDAT, 29 Jul 96

RAY E. McCOY
Major General, USA
Principal Deputy Director

SUBJECT: Evaluation of FY 1995 Defense Reutilization and Marketing Service Financial Data (Project No. 6LH-9006)

Recommendation C-2. We recommend that the Director, Defense Logistics Agency, direct the Defense Logistics Agency Internal Review Office to periodically evaluate the Defense Reutilization and Marketing Service's denials of inventory control point material requests.

DLA Comments: Concur. The IG report identified five denials from a single ICP. While these instances are disturbing, we do not believe five examples necessarily constitute a systems problem. The DLA Internal Review Office will, however, conduct a through review to determine the extent of the problem and action will taken as appropriate.

Disposition: Action is ongoing. Estimated Completion Date: September 1997.

Action Officer: Thomas Ruckdaschel, MMLC, (703)767-1534, July 16, 1996
Review/Approval: Randle D. Bales, CAPT, SC, USN, (703)767-2600, July 22, 1996
DDRI
DLA Approval:

RAY E. McCOY
Major General, USA
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This report was prepared by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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