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FINANCIAL REPORTING OF DLA-OWNED
BULK PETROLEUM PRODUCTS

Report No. D-2001-126

May 23, 2001

Office of the Inspector General
Department of Defense

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Acronyms

DLA	Defense Logistics Agency
DESC	Defense Energy Support Center
DFAMS	Defense Fuel Automated Management System
FAS	Fuel Automated System
FIA	Financial Inventory Account
NSN	National Stock Number



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May 23, 2001

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY
DIRECTOR, DEFENSE ENERGY SUPPORT CENTER

SUBJECT: Audit Report on Financial Reporting of DLA-Owned Bulk Petroleum
Products (Report No. D-2001-126)

We are providing this report for review and comment. We performed this audit in support of the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. We considered the comments received from the Defense Logistics Agency to be nonresponsive; therefore, we request additional comments on Recommendations 1., 2., and 3. by July 23, 2001.

For additional information on this report, please contact Mr. James L. Kornides at (614) 751-1400, extension 11 (jkornides@dodig.osd.mil) or Ms. Amy J. Frontz at (614) 751-1400, extension 13 (afrontz@dodig.osd.mil). See Appendix C for the report distribution. See the inside back cover for a list of audit team members.

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Office of the Inspector General, DoD

Report No. D-2001-126

(Project No. D2000FJ-0067.007)

May 23, 2001

Financial Reporting of DLA-Owned Bulk Petroleum Products

Executive Summary

Introduction. We performed this audit in support of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This is the fifth in a series of reports on the financial reporting of the inventory owned by the Defense Logistics Agency (DLA). Information on the other reports is contained in Appendix A. Bulk Petroleum Products consisting of aviation fuel, diesel fuel, lube oils, and additives were a significant part of the inventory that DLA owned at the end of FY 2000. Bulk Petroleum Products comprised approximately \$2.3 billion (24 percent) of the \$9.5 billion of inventories that DLA reported on its FY 2000 financial statements.

Objectives. The overall objective for the audit was to evaluate management assertions pertaining to existence, completeness, and valuation of DoD inventory accounts, and to determine whether those accounts are presented fairly on the financial statements. For this part of the audit we evaluated the existence and completeness of DLA-owned bulk petroleum products and whether the inventory account is represented fairly on the DLA financial statements. We also evaluated applicable management controls. See Appendix A for a complete discussion of scope, methodology, management control program, and prior audit coverage.

Results. The inventory process used by DLA to capture and report the cost of its \$2.3 billion bulk petroleum product (fuel) inventory for the FY 2000 Financial Statements was not adequate. DLA did not complete inventories at all of its fuel storage sites, reconcile inventory balances, process fuel transactions in a timely manner, or account for all financial transactions related to fuel in the proper accounting period. Approximately \$1.4 billion (61 percent) of the \$2.3 billion of the bulk petroleum stored at approximately 511 sites was either not inventoried or was inventoried but not reconciled prior to preparation of the financial statements. Additionally, inadequate processing and accounting for fuel transactions caused 6 million gallons of negative inventory to be reported and at least \$6.4 million of DLA-owned fuel not to be included on the DLA balance sheet. As a result, until the above mentioned deficiencies are corrected, the \$2.3 billion fuel portion of the DLA inventory line cannot be relied upon to support the inventory amounts reported in the DLA Financial Statements. See the Finding section for a discussion of audit results.

Summary of Recommendations. We recommend that the Director, Defense Energy Support Center conduct and reconcile inventories at every fuel site before the financial statements are compiled and produced. Any adjustment derived from the reconciliation should be reflected in the final inventory number. We recommend that the Director, Defense Energy Support Center develop additional procedures to ensure that fuel site personnel properly process transactions in a timely manner. We recommend that the Director, Defense Energy Support Center account for all transactions in the proper accounting period. Specifically, the subsidiary ledger should be date driven and accept all late transactions that are not processed timely but occur in the financial accounting period. We recommend that the Defense Fuel Automated Management System replacement system be designed to properly account for barge transactions.

Management Comments. The Director, Defense Energy Support Center, nonconcurred with the finding and partially concurred with each recommendation. The Director stated that no actions are warranted because the report contained significant misstatement of fact and that the DLA fuel inventory processes were adequate. The Director indicated that DLA already had existing controls in place to ensure the fuel sites conduct and reconcile inventories in a timely manner. The Director stated 91.5 percent of the inventories were entered in the records by the end of October and 99 percent were entered into the records by the end of December. The Director also stated that DLA already had procedures in place to account for all transactions in the proper accounting period. In addition, the Director indicated the report incorrectly portrays the processing of transactions as it relates to negative fuel inventory. The Director stated that the Defense Fuel Automated Management System replacement system would correct other deficiencies outlined in the audit report. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

Audit Response. We disagree with the Director, Defense Energy Support Center comments that the finding contained misstatements of fact and that no actions are needed. The Director's comments contain general statements but no specific information documenting factual errors in the report. We would agree that 91.5 percent of the inventories were entered into the records by October 31, 2000, and 99.0 percent were entered by December 31, 2000, because it supports our conclusions that the timeliness of physical inventories and the reconciliation process were inadequate. The Defense Finance and Accounting Service said October 5, 2000, was the cutoff period for the fiscal year for fuel inventories so entries to the records after then would not be in the year end balances. We did sufficient testing to prove that DLA did not have adequate controls to ensure timely physical inventory and reconciliation of fuel balances, to ensure transactions were accounted for in the proper accounting period, and to prevent the reporting of negative inventory balances in the subsidiary ledger. Our conclusions were based on data collected from 33 fuel sites and information in the Financial Inventory Report. That information showed that management controls did not ensure that there was timely processing of fuel transactions. A subsequent review of DESC practices by a contractor hired by DLA noted similar problems with the processing of fuel transactions. Actions are needed because these management control weaknesses prevent us from relying on the fuel balances incorporated in the inventory amounts on the DLA financial statements. We request that the Director, Defense Energy Support Center provide additional comments on the final report by July 23, 2001.

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Background

We performed this audit in support of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This report is the fifth in a series of reports on the amounts of DLA inventories reported on the DoD financial statements. Prior reports discussed chemical suits, tests of dollar value accuracy, and unit pricing at the inventory control points in Columbus, OH, Richmond, VA, and Philadelphia, PA.

Bulk petroleum products consist of aviation fuel, diesel fuel, lube oils, and additives. Those petroleum products are a part of the Defense Logistics Agency (DLA) inventory and are reported as part of the inventory amount reported on the DLA financial statements.

Bulk petroleum products represented about \$2.3 billion (24 percent) of the \$9.5 billion of DLA inventory. The petroleum products were stored at approximately 511 Defense Fuel Sites. The 511 fuel sites managed 864 line items that were reflected in the DLA Financial Inventory Account (FIA) subsidiary ledger.

Management is responsible for presenting accurate and reliable inventories in accordance with generally accepted accounting principles. Underlying the financial statements are management assertions on the existence, completeness, valuation, ownership, and presentation of inventories. This report focuses on the assertions of existence and completeness. Existence deals with whether assets or liabilities exist at a given date. Completeness deals with whether all transactions and accounts that should be presented in the financial statements are so included.

Defense fuel site personnel are responsible for maintaining accurate inventory records and confirming inventory quantities within the accounting records by measuring product levels, which is the most important internal control for fuel inventories. Accurate inventory records are essential to achieving DoD goals for operating readiness, total asset visibility, financial and budget reliability, and operating efficiencies. Accurate inventory records can also help the Defense Energy Support Center (DESC) to demonstrate that essential management controls are in place to safeguard DoD inventories stored at the fuel sites.

DLA uses the Defense Fuel Automated Management System (DFAMS) in support of their bulk petroleum products management operations. All petroleum related transactions flow through the DFAMS system. To help manage fuel operations, DLA is working on implementing a new system called the Fuels Automated System (FAS). The FAS migratory program was initiated to evolve and modernize the existing DFAMS to support the DoD mission requirements. The mission requirements include management and accountability of fuel stored at installations, a responsibility previously belonging to the Military Services. FAS is scheduled to replace DFAMS in September 2003. The implementation

schedule has been delayed due to numerous design changes and programming problems. DLA was scheduled to implement FAS at a few test sites in April 2001.

Objectives

The overall objective for the audit was to evaluate management assertions pertaining to existence, completeness, and valuation of DoD inventory accounts and to determine whether those accounts are presented fairly on the financial statements. For this part of the audit we evaluated the existence and completeness of DLA-owned bulk petroleum products and whether the inventory account is represented fairly and accurately on the DLA financial statements. We also evaluated applicable management controls. See Appendix A for a complete discussion of the scope, methodology, management control program review and prior audit coverage.

Inventory of Defense Logistics Agency- Owned Bulk Petroleum Products

The inventory process used by the Defense Logistics Agency (DLA) to capture and report the cost of its \$2.3 billion bulk petroleum product (fuel) inventory for the FY 2000 financial statements was not adequate. DLA did not accomplish the following:

- complete inventories at all of its fuel sites as required,
- use reconciled inventory balances in the preparation of their financial statements,
- process fuel transactions in a timely manner, or
- account for all financial transactions related to fuel in the proper accounting period.

Approximately \$1.4 billion (61 percent) of the \$2.3 billion of the bulk petroleum dollar value stored at approximately 511 sites¹ was either not inventoried or was inventoried but not reconciled prior to preparation of the financial statements. Additionally, the inadequate processing and accounting for fuel transactions caused 6 million gallons of negative inventory to be reported and at least \$6.4 million of DLA-owned fuel not to be included on the DLA balance sheet. As a result, until the deficiencies are corrected, the \$2.3 billion fuel portion of the DLA inventory line cannot be relied on to support the inventory amounts in the DLA financial statements.

Completing and Reconciling Inventories

During FY 2000, DLA partially concurred with an Inspector General, DoD, audit recommendation² to expand its sampling procedures or develop other procedures to validate the accuracy of inventory records for fuels. DLA responded to the audit by stating that DLA relies on its internal controls and the controls established by the organizations that store DLA-owned materiel, but agreed to validate the existing procedures to determine whether additional procedures were required. However, DLA chose not to use statistical sampling methods to

¹ There were approximately 511 fuel sites, contained in the Financial Inventory Account report, as of September 30, 2000. A fuel site is defined as an activity, such as a DFSP, pipeline, contractor-owned facility, etc. that holds DLA-owned fuel. The number of fuel sites is subject to change due to the continuous capitalization of military bulk petroleum products by DLA.

² Inspector General, DoD, Report No. D-2000-138, "Procedures Used to Test the Dollar Accuracy of the Defense Logistics Agency Inventory," June 1, 2000.

determine the dollar value accuracy of DLA-owned fuel because DLA believed it had the capability to obtain 100 percent fuel inventories at all fuel sites at year-end.

Despite those assurances, DLA did not complete all fuel inventories in time for financial statement reporting and did not use reconciled inventories in preparation of the FY 2000 DLA Financial Statements. We examined the DLA FIA subsidiary ledger to determine whether inventories were conducted on time and reconciled in time to support financial statement preparation. The FIA is the supporting subsidiary ledger for the FY 2000 DLA Financial Statements.

Completing Inventories. DoD Regulation 4140.1-R, the “DoD Materiel Management Regulation,” May 20, 1998, and DoD Manual 4140.25-M “DoD Management of Bulk Petroleum Products, Natural Gas, and Coal,” June 1994, establishes policy for inventory management records and for devoting the resources necessary to complete inventories. Those procedures were implemented by DLA. However, DLA was not ensuring that the inventories were completed in time for input and preparation of the FY 2000 DLA financial statements.

Specifically, the September 30, 2000, subsidiary ledger indicated that only 230 (27 percent) of the 864 line item inventories valued at \$853 million were completed and reconciled in time to prepare the FY 2000 DLA Financial Statements. However, 476 (55 percent) of the 864 line items, valued at \$1.1 billion, were not inventoried by the fiscal year-end cutoff.

We attribute this condition to the lack of timely enforcement of existing procedures at fuel sites. DLA personnel were not ensuring that the inventories were completed in time for compilation of financial information used in the financial statements. Accurate and reliable information cannot be developed unless the inventories are completed by the end of the reporting period.

Reconciling Inventories. “DoD Financial Management Regulation”, volume 11B, chapter 55 December 1994 states that at least quarterly, line item accountability records shall be reconciled to balances recorded in the general ledger inventory accounts. In addition, accounting records should be adjusted to be in agreement with the results of physical inventories when they are taken.

Although DLA implemented the policy, it was not always followed. There were 158 (18 percent) of the 864 Bulk Petroleum Product line items, valued at \$322 million, that DLA personnel inventoried but did not reconcile to balances in the general ledger account in time for financial statement reporting.

There were several reasons for the unreconciled inventories. In some instances, the line items were still being researched for fuel inventory variances at the time of financial statement cutoff. In other cases, inventory items were not properly closed out in the inventory system. However, the main reason that the inventories were not reconciled was because the fuel sites had not processed all of the receipt and issue transactions in a timely manner.

Processing of Transactions

DLA fuel sites carried National Stock Number (NSN) items with negative product balances during FY 2000. We attributed this condition to the untimely processing of fuel transactions. Our analysis of the various monthly transactions showed that receipts were often not recorded for several days or even weeks after the transactions occurred.

This late recording of transactions created a situation that resulted in more issues being recorded than the balance of the product in the inventory system, giving the appearance of negative inventory. During FY 2000, 17 fuel sites carried NSNs with negative inventory balances for multiple quarters (see Appendix B). This indicated that those storage sites were consistently processing transactions in an untimely manner.

An analysis of inventory balances as of September 30, 2000, indicated that 21 NSNs were carrying a negative balance of six million gallons of bulk petroleum product valued at a negative \$6.4 million dollars at the end of FY 2000. The negative balances were captured in the financial statements. As shown in following table, negative balances were common at the end of each quarter for the analysis conducted from September 1999 through September 2000.

Quarterly Negative Fuel Balances			
Month	Total Gallons	Total Dollars (Acq Cost Adjusted)	Negative NSNs
September 1999	(3,910,209)	(\$2,527,552.90)	15
December 1999	(10,223,602)	(7,373,611.19)	20
March 2000	(6,869,578)	(5,944,401.97)	15
June 2000	(6,653,132)	(5,364,495.07)	28
September 2000	(6,017,920)	(6,418,255.79)	21

DLA has been reporting negative inventory balances in the subsidiary ledger since 1991. However, DLA has never corrected those problems.

Negative Inventory Dollar Value. We evaluated negative inventories from the DFAMS FIA subsidiary ledger. To determine the causes of the negative inventory we examined the records of negative fuel for one month, April 2000. We chose this month because it was completed as we began our fieldwork. The records indicated negative petroleum balances at 28 different sites. Of the 28 sites, 20 had negative inventories valued at \$6.3 million because of the untimely processing of transactions. DESC personnel provided information that showed the fuel sites received fuel but did not post the receipts to the DFAMS system in the required time. When fuel is issued and postings are made to the subsidiary ledger, balances will become negative if the receipts have not been posted to the subsidiary ledger, even though fuel is on hand.

At the 20 sites, the fuel records indicated that the true value of their on-hand inventory was a positive \$6 million at month end. The effect was a difference of \$12.3 million from the negative \$6.3 million amount reported in the DLA April trial balance. Although, the \$12.3 million difference we noted in the April trial balance was not a material amount in relation to the \$2.3 billion of fuels, its appearance is an indicator of a systemic control weakness.

The remaining eight sites had negative inventory balances due to the DFAMS inability to handle the accounting for barge transactions. A fuel barge is a sea-based ship that sails from site to site to deliver a product. They are distinguished from tankers, which are land-based trucks that drive between destinations. DoD Manual 4140.25-M states that tanker and barge losses and gains are calculated at the final discharge point. The DFAMS system was not designed to account for barge transactions. As a result, DESC recognizes the receipt by the barge at final destination, which causes a negative balance in the inventory figure. However, the negative balances are offset by positive balances in the in-transit account. DLA is in the process of developing a replacement system for DFAMS and needs to ensure that the replacement system corrects this problem.

Fuel sites that had positive inventory balances were not examined. However, the possibility exists that the sites that were carrying positive inventory values were also under or overstated due to the lack of internal controls over the processing of transactions. Until the controls over the processing of fuel transactions are improved, the inventory amounts cannot be relied upon to support the DLA financial statements.

Accounting Period

An objective of accrual based accounting is to ensure that events that change an entity's financial statements are recorded in a period in which the event occurs, rather than only in the period in which the event is recorded. When inventory records are maintained in a perpetual inventory system, receipts and issues should be recorded directly into the inventory system as they occur. The balance of inventory at the end of a fiscal year should represent the ending inventory amount.

Subsidiary Ledgers. A fiscal year-end analysis of the DLA subsidiary ledgers supporting the bulk petroleum inventory trial balance, beginning with September 30, 1999, showed that DLA did not account for transactions in the proper accounting period. The purpose of our analysis was to determine whether the subsidiary ledgers were properly cutoff at month and year-end; therefore, capturing all transactions for the proper fiscal year. A cutoff is an end date after which no additional postings to a ledger are made for a given period.

The subsidiary ledgers were not properly cut off at year-end. The fiscal year-end cutoff dates were October 4, 1999, and October 4, 2000. The year ending FY 1999 and FY 2000 bulk petroleum subsidiary ledgers were kept open in order to capture all the late year ending transactions. The ledger did not capture all FY 2000 transactions because some of the fuel sites contained negative inventory values at fiscal year-end, indicating that the transactions had not been completed. In addition, no steps were taken to prevent FY 2001 transactions from being

posted to the FY 2000 subsidiary ledger. The subsidiary ledger needs to be left open, but must be driven by the date the transaction occurred. This will allow late transactions from the current fiscal year to be processed, but avoid processing the transactions from the subsequent accounting period.

Conclusion

The DLA inventory line cannot be relied upon to support the inventory amounts reported in the DLA financial statements until the internal control problems associated with conducting and reconciling inventories and processing transactions in the proper accounting period are corrected. Failure to conduct inventories and use reconciled balances prohibited DLA from providing assurance to the existence and completeness of the bulk petroleum product subsidiary ledger and trial balance. It is imperative for inventory accuracy purposes that all inventories are conducted and reconciled, and inventory adjustments made, prior to the issuing of the financial statements. DLA needs to enforce procedures that require the fuel sites to complete the inventories and perform the necessary reconciliations prior to the preparation of the financial statements. Although problems exist with the reporting of bulk petroleum transactions and physical inventory quantities, these problems can be corrected without any major system changes. However, DLA needs to ensure that the new automated system for Bulk Petroleum Product reporting addresses the deficiencies. DLA also needs to ensure that all transactions are properly processed before the financial statement cutoff reporting date.

Management Comments on the Finding and Audit Response

Management Comments. DLA nonconcurred with the finding and stated that no action is warranted in response to the recommendations because the report contained significant misstatement of fact, and that the DLA fuel inventory processes were adequate. DLA stated the auditors overstated the impact and did not believe the auditors visited enough fuel sites to understand the processing of fuel transactions. In addition, there was adequate guidance for the personnel responsible to perform the inventories, even though the personnel at many of the fuel sites are not under the authority of DLA.

Audit Response. The DLA comments provided no specific example of factual errors in the report. We performed sufficient fieldwork to fully understand the processing of fuel. We visited or contacted 33 sites during the audit to gain an understanding of the inventory procedures and the reasons for untimely processing of transactions, and the causes of the negative fuel balances. In addition, we analyzed the FIA used to support the reported value of bulk petroleum on the FY 2000 DLA financial statements. As indicated in the report, the data show that fuel inventories were not completed or reconciled in a timely manner and that negative inventory balances have been reported in the subsidiary ledger since 1991. Additionally, a subsequent review by a contractor hired by DLA to audit the FY 2000 DLA financial statements noted similar issues with the processing of fuel transactions and the reporting of negative fuel inventory balances.

Management Comments. DLA stated that the report does not tell the reader that operating personnel at many fuel sites are not under their authority and timely transaction posting depends on the priorities of the Military Departments operating the sites.

Audit Response. We understand that DLA relies on the Military Departments to manage the fuel sites. However, DLA is responsible to ensure that the Military Departments perform inventories and report transactions in a timely manner. If the Military Departments are not performing the required procedures, DLA should take actions to ensure the procedures are enforced.

Management Comments. DLA indicated that the auditors statement that 476 (55 percent) of 864 line items, valued at \$1.1 billion, were not inventoried by fiscal year-end cutoff was not correct. DLA stated that 91.5 percent of the inventories completed by September 30, 2000, were entered into DFAMS by the end of October 2000 and 99.0 percent were entered into DFAMS before the end of December 2000. DLA maintains that the monthly FIA report as of October 5, 2000, is not the subsidiary ledger used to report the fuel inventory on the DLA financial statements.

Audit Response. Our analysis of the FIA report as of October 5, 2000, supports the conclusion that 476 line items were not inventoried. DFAS provided the October 5, 2000, FIA as the support for the fuel inventory balance reported on the FY 2000 DLA Financial Statements. The DLA statement that only 91.5 percent of the physical inventories were completed by the end of October 2000 and only 99.0 percent were completed by the end of December 2000 further supports our conclusion that the timeliness of the physical inventories and reconciliation process for fuel inventories was inadequate.

Management Comments. DLA stated that a material difference did not exist between the physical inventory count and the book value of inventory reported at year-end. An adjustment was not required for the DLA financial statements to be fairly presented.

Audit Response. The purpose of performing physical inventories and reconciling them is to verify that the accountable records accurately represent the value of on-hand assets. DoD Regulation 7000.14-R requires that physical inventories be taken in accordance with the procedures prescribed in DoD Regulation 4140.1-R and that general ledgers be adjusted for differences between general ledger balances and the physical count. Based on the results of our audit, this was not occurring.

Management Comments. DLA stated that the finding concerning the timely posting of accounting transactions in the proper accounting periods was incomplete and not factual. DLA stated that it has controls in place to ensure that accounting transactions are posted in the proper accounting month. DLA indicated it maintains a file for transaction processing and a file for general ledger posting in DFAMS. These two files enable posting of transactions in the correct month because they both contain current accounting month and current accounting month plus one.

Audit Response. The audit identified 20 fuel sites that were not processing receipt transactions on a timely basis. DLA indicates it has controls in place to ensure that accounting transactions are posted in the proper accounting period. If the proper cutoffs and inventory reconciliation processes were in place, DLA would not have reported negative inventory balances.

Management Comments. DLA stated that the report incorrectly portrayed the process of transactions as it relates to negative fuel inventory. DLA indicated that the accounting for fuel barges caused the negative fuel balances.

Audit Response. This report acknowledged that the legacy system was unable to properly account for fuel in-transit transactions related to fuel barges. However, the report focused on the 20 fuels sites that reported negative inventory not related to fuel barge accounting.

Management Comments. DLA stated that the \$2.3 billion of fuel was not materially misstated and does not believe the recommended actions warranted any consideration. However, DLA would consider any findings and recommendations addressed by the contractors it hired to audit the DLA balance sheet accounts.

Audit Response. As noted in management's response DLA included the fuel operation in the scope of the DLA contract with Deloitte and Touche to audit the DLA balance sheet accounts. In the Deloitte and Touche assessment report for FY 2000, the timeliness of the physical inventories and reconciliation process were considered inadequate. Deloitte and Touche also noted that if proper cutoffs and reconciliation were performed, DLA would not report negative inventory balances.

The audit report addressed material internal control deficiencies related to the timeliness of inventories and reconciliation for fuel transactions. Although the fuel data did not indicate a material misstatement of the DLA financial statements, the timeliness of recording and reconciling transactions prevented us from being able to rely on the reported DLA fuel inventory. Until management acknowledges and corrects the internal control deficiencies noted in the report, the \$2.3 billion fuel portion of the DLA inventory line cannot be relied on to support the inventory amounts in the DLA financial statements.

Recommendations, Management Comments and Audit Response

We recommend that the Director, Defense Energy Support Center:

1. Implement procedures to follow up with activities that are regularly processing transactions in an untimely manner. Specifically, the procedures need to:

a. ensure the fuel sites conduct and reconcile all inventories at all Defense Fuel activities before the financial statements are produced, and;

b. reflect any adjustment derived from the reconciliation process in the final inventory number.

Management Comments. DLA partially concurred and stated that the existing procedures in place are adequate. DLA stated that 99 percent of the inventory results were completed by December 31, 2000, and an adjustment was not warranted to the financial statements.

Audit Response. Although DLA partially concurred, we consider the comments to be nonresponsive. The audit report noted that a material amount (61 percent) of the fuel inventory was either not inventoried or was inventoried but not reconciled to the accounting records in a timely manner as of the fiscal year-end. The purpose of performing physical inventories and reconciling is to verify that the accountable records accurately represent the value of on-hand assets. DoD Regulation 7000.14-R requires that physical inventories be taken in accordance with the procedures prescribed in DoD Regulation 4140.1-R and that general ledgers be adjusted for differences between general ledger balances and physical count. The timeliness of the physical inventories and reconciliation process for fuel inventories is inadequate. We request that DLA reconsider the comments and provide comments to the final report.

2. Provide additional guidance to the fuel activities on DoD policies for processing transactions in timely manner. Specifically, ensure personnel are aware of DoD policy regarding the posting of receipts and issues into the inventory system.

Management Comments. DLA partially concurred and stated that the DoD policies are adequate and there is no reason to issue additional guidance. DLA further stated that it maintains frequent communication with the field and will continue to do so as warranted.

Audit Response. Although DLA partially concurred, we consider the comments to be nonresponsive. The audit showed a material amount of fuel was either not inventoried or was inventoried but not reconciled to the accounting records in a timely manner as of the fiscal year-end. Our analysis of several month-end inventories showed on a consistent basis that the inventories were not completed

or reconciled in a timely manner. DLA is responsible for ensuring that the Military Departments perform inventories and report transactions in a timely manner. Furthermore, if the Military Departments are not performing the required procedures for maintaining the fuel inventory, DLA should take actions to notify the appropriate DoD officials. We request that DLA reconsider its comments and provide comments to the final report.

3. Perform interim procedures to cut off the subsidiary ledger at year-end and account for all transactions in the proper accounting period.

Management Comments. DLA partially concurred and stated that the existing cut-off procedures for the current legacy system are adequate.

Audit Response. Although DLA partially concurred, we consider the comments to be nonresponsive. The audit identified 20 fuel sites not related to the barges that were reporting negative inventory balances at year-end. In addition, the negative fuel inventory balances have been reported since FY 1991. If proper cutoffs and inventory reconciliation processes were in place, the fuel sites would properly reflect the actual fuel inventory on hand. We believe that DLA needs to ensure that all transactions are properly processed before the financial statement cutoff reporting date and correct the systemic problem of reporting negative inventory balances. We request that DLA reconsider its comments and provide comments to the final report.

4. Ensure that the Defense Fuel Automated Management System replacement system properly accounts for the deficiencies outlined in this report. Specifically, the system should:

a. be date driven to account for all transactions in the proper accounting period, and;

b. properly account for barge transactions in accordance with DoD Manual 4140.25-M.

Management Comments. DLA partially concurred and stated that the requirements are known and will be addressed in the replacement system.

Appendix A. Audit Process

Scope

We performed this audit as part of the requirements of Public Law 101-576, the “Chief Financial Officers Act of 1990,” November 15, 1990, as amended by Public Law 103-356, the “Federal Financial Management Act of 1994,” October 13, 1994. For this part of the audit, we limited the scope of our review to verify the accuracy of bulk petroleum inventory data reported on the DFAMS FIA subsidiary ledger.

Work Performed. We performed the audit at DESC headquarters, DFAS Columbus and four of the 511 fuel sites. We analyzed data for 511 sites whose total bulk petroleum products were valued at \$2.3 billion. We tested the fuel trial balance subsidiary ledger for completeness and existence. In addition, we performed cutoff analysis on the quarterly and the end of FY 2000 DFAMS FIA subsidiary ledgers. We performed site visits to selected activities and performed physical inventories to verify the accuracy of the data reported within the FIA. To determine the accuracy we compared the quantities we inventoried with the activity-reported quantities. We then compared activity-reported quantities with those that appear on the FIA report to ensure the accuracy of data flow. In addition to the site visits we contacted 20 sites containing negative inventories. We obtained an accurate inventory reading at the time the FIA was produced and compared the true inventory balance to the negative balance in order to calculate the understatement to inventory.

Limitations to Audit Scope. Our audit was limited to determining accuracy of information reported in the DFAMS FIA subsidiary ledger, which feeds the bulk petroleum product value to the DLA trial balance. We did not attempt to determine the impact that erroneous pricing data or other valuation problems may have on the value reported.

DoD-Wide Corporate-Level Government Performance and Results Act (GPRA) Coverage. In response to the GPRA, the Secretary of Defense annually establishes DoD-wide corporate-level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following corporate-level goal, subordinate performance goal, and performance measure.

FY 2001 DoD Corporate-Level Goal 2: Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-02)**

- **FY 2001 Subordinate Performance Goal 2.5:** Improve DoD financial and information management. **(01-DoD-2.5)**

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

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

Financial Management Functional Area. Objective: Reengineer DoD business practices. **Goal:** Standardize, reduce, clarify, and reissue financial and inventory management policies. **(FM-4.1)**

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

Methodology

We reviewed Federal accounting standards and DoD and DLA policies and procedures for accounting, inventorying, and reporting of bulk petroleum products. We also interviewed various DESC, as well as Military Department personnel, involved in the accounting, inventorying, and reporting of bulk petroleum products. We performed a review of the subsidiary ledger, which contains the financial transaction summary for all bulk petroleum NSNs at each activity and serves as the source for the DLA bulk petroleum product trial balance. We conducted analysis of the subsidiary ledger for completeness and existence. In addition, we performed cutoff analysis on the subsidiary ledger. We performed site visits to selected activities and performed physical inventories to verify the accuracy of the data reported within the FIA. In addition to the site visits we contacted 20 sites containing negative inventories. We obtained an accurate inventory reading at the time the FIA was produced and compared the true inventory balance to the negative balance in order to calculate the understatement to inventory.

Use of Computer-Processed Data. To achieve the audit objective, we relied on computer-processed data from the DLA DFAMS. We did not test general and application controls in DFAMS. Specifically, we analyzed the gallons and the value of petroleum reported within the FIA report.

Audit Type, Dates, and Standards. We performed our financial-related audit from April 2000 through February 2001. Our review was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

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

Management Control Program Review

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

Scope of the Review of the Management Control Program. We reviewed the FY 2000 Annual Statements of Assurance issued by DLA to determine whether the issues addressed in this report had been reported as material management control weaknesses.

Adequacy of Management Controls. We identified material management control weaknesses, as defined by DoD Instruction 5010.40, related to the reporting of DLA-owned bulk petroleum products. The details of the management control weaknesses are provided in detail in the Finding section of this report. All of the recommendations in this report, if implemented, will improve the accuracy and reliability of DLA-owned bulk petroleum products. A copy of this report will be provided to the senior official responsible for management controls at DLA.

Adequacy of Management's Self-Evaluation. The FY 2000 DLA Annual Statement of Assurance did not identify any material control weakness related to the inventorying or reporting of DLA-owned bulk petroleum products.

Prior Coverage

Inspector General, DoD

Inspector General, DoD, Report No. D-2001-079, "Inventory Valuation at the Defense Supply Center Richmond," March 14, 2001

Inspector General, DoD, Report No. D-2001-078, "Inventory Valuation at the Defense Supply Center Columbus," March 14, 2001

Inspector General, DoD, Report No. D-2000-138, "Procedures Used to Test the Dollar Accuracy of the Defense Logistics Agency Inventory," June 1, 2000

Inspector General, DOD, Report No. D-2000-086, "Assuring Condition and Inventory Accountability of Chemical Protective Suits," February 25, 2000

Appendix B. Negative Inventory Balances

Department of Defense Activity Address Codes with National Stock Numbers Carrying Negative Inventory Balances at the end of Several Quarters						
DoDAAC	September 1999	December 1999	March 2000	June 2000	September 2000	Total Quarters
FP2823			Yes	Yes	Yes	3
FP4417	Yes	Yes	Yes	Yes		4
FP4897	Yes				Yes	2
FP5284	Yes	Yes	Yes	Yes		4
FP6031	Yes	Yes		Yes		3
FP6041	Yes	Yes				2
FP6042		Yes		Yes		2
FP6151		Yes		Yes		2
FP6302		Yes		Yes		2
FP6311			Yes	Yes		2
FP6432	Yes	Yes	Yes	Yes	Yes	5
M67865			Yes		Yes	2
N00213		Yes	Yes			2
N00216	Yes	Yes		Yes*	Yes	4
UY7031	Yes	Yes				2
UY7235	Yes	Yes	Yes	Yes		4
W51HU8			Yes	Yes		2
17 DoDAACs	* Indicates 2 negative NSNs in the given month					

The above activities had negative inventory balances occurring or reported at the end several quarters. There were 49 other activities that had negative balances in only one quarter.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Defense Logistics Agency
Director, Defense Energy Support Center

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
DEFENSE ENERGY SUPPORT CENTER
8725 JOHN J. KINGMAN ROAD, SUITE 4950
FORT BELVOIR, VIRGINIA 22060-6222

MAR 29 2001

IN REPLY
REFER TO DESC-DI

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

THROUGH: DLA Logistics Operations Internal Review Office, J-308

SUBJECT: Draft Report on Financial Reporting of DLA-Owned Bulk Petroleum
Products (Project No. D2000FJ-0067.007)

Attached are our comments on the subject draft report. Please contact Ms. Emilia
Snider at (703) 767-9671 or by e-mail at esnider@desc.dla.mil if you have any questions.


for JEFFREY A. JONES
Director

Attachment

Subject: Draft Report on Financial Reporting of DLA-Owned Bulk Petroleum Products, Project No. D2000FJ-0067.007

Finding: The inventory process used by the Defense Logistics Agency (DLA) to capture and report the cost of its \$2.3 billion bulk petroleum product (fuel) inventory for the FY 2000 financial statements was not adequate. DLA did not accomplish the following:

- complete inventories at all of its fuel sites as required,
- use reconciled inventory balances in the preparation of their financial statements,
- process fuel transactions in a timely manner, or
- account for all financial transactions related to fuel in the proper accounting period.

Approximately \$1.4 of the \$2.3 billion (61 percent) of the bulk petroleum dollar value stored at approximately 511 sites was either not inventoried or was inventoried but not reconciled prior to preparation of the financial statements. Additionally, the inadequate processing and accounting for fuel transactions caused 6 million gallons of negative inventory to be reported and at least \$6.4 million of DLA-owned fuel not to be included on the DLA balance sheet. As a result, until the deficiencies are corrected, the \$2.3 billion fuel portion of the DLA inventory line cannot be relied on to support the inventory amounts in the DLA financial statements.

DLA Comments:

Nonconcur. We do not believe that any action is warranted in response to the recommendations in this audit report because the report contains significant misstatements of fact, and overstates the overall impact that the auditors' observations have on the financial statements. This occurred because, in our opinion, the auditors did not visit enough fuel sites or do enough audit work to understand how fuel transactions and physical inventories are recorded in our automated system and based their conclusion on an incomplete understanding of the facts.

The report states that a year-end inventory count was not performed at all fuel sites as required. The report does not tell the reader that operating personnel at many of the fuel sites are not under our authority and timely transaction posting depends on the priorities of the Military Departments operating the sites. The auditors did not attempt to determine which fuel sites posted the results of their year-end inventory counts timely and why or why personnel at other fuel sites were not as timely in posting their year-end inventory results. The audit report, however, indicates that "untimely" transactions were caused by a lack of guidance or that the personnel at some fuel sites were not aware of DoD policy regarding the posting of receipts and issues into the inventory system.

The report indicates that "476 (55 percent) of the 864 lines items, valued at \$1.1 billion, were not inventoried by fiscal year-end cut-off". That statement is not correct. If the auditors had properly analyzed the available information, they would have found that 91.5 percent of the physical inventories performed on September 30 were entered into

DFAMS before the end of October 2000 and 99.0 percent were entered into DFAMS before the end of December 2000.

The auditors apparently based their conclusion on the monthly FIA Inventory Report as of October 5, 2000. This report shows the transactions entered into DFAMS as of October 5, 2000. This report is not a “subsidiary ledger that feeds into DFAMS” as stated in the Appendix A of the audit report. The FIA report is a report of transactions that were entered into DFAMS as of month close. If the count was performed but was not entered into DFAMS until after the October 5, 2000 general ledger year-end closing date, then the physical inventory count would not be reported on the FIA report. This does not mean that the physical inventory count did not occur. It also does not mean the issue and receipt book transactions were not posted to the general ledger.

Another item in the audit report was the reconciliation of inventories and adjusting the amount to the physical inventory. Since a material difference did not exist between the physical inventory count and the book value of the inventory reported at year-end, an adjustment was not required in order for our financial statements to be fairly presented. Had a material difference existed we would have adjusted the inventory amount to a dollar value that reasonably represented the inventory count.

The audit finding concerning timely postings and proper accounting periods was incomplete and not factual. DFAMS maintains two “Run Control Files”, one for transaction processing and one for general ledger posting. These files both contain the current accounting month and current accounting month plus one. By having these two months open, we are able to post transactions in the correct month. The transaction dates of transactions that are entered into DFAMS determine which accounting month will be posted. For example, if a transaction occurs in October and has an October transaction date and the September accounting month is still open then it will post to “accounting month plus one.” September transactions will be posted to September month. When month-end rollover is performed, the transaction Run Control File is changed to make October the current month, so that no more transactions will receive a September accounting month. However, September transactions can still post to the general ledger via Journal Vouchers until the “General Ledger Rollover” occurs which changes the General Ledger Run Control file to contain October in the current month. Using these controls we ensure that accounting transactions are posted in the proper accounting month.

The audit report also incorrectly portrays the process of transactions as it relates to negative fuel inventory. We explained to the auditors that negative balances are reflected in our records temporarily when fuel “in-transit” is being lifted from a barge, and the issue transactions are recorded in DFAMS before the transaction recording the status change of “in-transit” fuel has been recorded. This inventory is recorded in inventory accounts 140 and 141 in our general ledger. Apparently, the audit failed to include this inventory. This is a limitation of our existing legacy system. However, the “negative” inventory balances reported in this audit are not material, representing much less than 1% (actually 0.26%) of our total inventory.

We do not concur that our inventory processes were not adequate within the constraints of the existing legacy system or that the \$2.3 billion of fuel was materially misstated in the financial statements. For these reasons, we do not believe that the recommended actions are warranted based on the work done by the auditors. However, fuel operations are included in the scope of the DLA contract with Deloitte and Touche to audit the DLA balance sheet accounts. Once they complete their work, we will consider any of their findings and recommendations to determine if further action is required with regard to our fuel inventory processes.

Action Officer: Richard Sninsky, DESC-R, (703) 767-8455

Approval: Carol O'Leary, Director, DESC-R, (703) 767-9450

Subject: Draft Report on Financial Reporting of DLA-Owned Bulk Petroleum Products,
Project No. D2000FJ-0067.007

Recommendation 1: We recommend that the Director, Defense Energy Support Center implement procedures to follow up with activities that are regularly processing transactions in an untimely manner. Specifically the procedures need to:

- a. ensure the fuel sites conduct and reconcile all inventories at all Defense Fuel activities before the financial statements are produced, and;
- b. reflect any adjustment derived from the reconciliation process in the final inventory number.

DLA Comments:

Partially concur. As indicated above, about 99 percent of the inventory results had been reported prior to December 31, 2000. Had adjustments been warranted, which they were not, we would have been able to make adjustments in time to prepare the financial statements. Consequently, we believe that the existing procedures already in place are adequate.

() Ongoing. Estimated completion Date:
(x) Considered Complete.

Action Officer: Richard Sninsky, DESC-R, (703) 767-8455

Approval: Carol O'Leary, Director, DESC-R, (703) 767-9450

Subject: Draft Report on Financial Reporting of DLA-Owned Bulk Petroleum Products,
Project No. D2000FJ-0067.007

Recommendation 2: Provide additional guidance to the fuel activities on DoD policies for processing transactions in timely manner. Specifically, ensure personnel are aware of DoD policy regarding the posting of receipts and issues into the inventory system.

DLA Comments:

Partially Concur. We believe that DoD policies are adequate and there is no reason to issue additional guidance. The audit report did not indicate that the auditors had identified any personnel in any fuel site who were not aware of the DoD policies. Additionally, the auditors did not evaluate the amount or frequency of our communication with the field. We routinely provide guidance to the field and will continue to do so as situations warrant.

() Ongoing. Estimated completion Date:
(x) Considered Complete.

Action Officer: Richard Sninsky, DESC-R, (703) 767-8455
Approval: Carol O'Leary, Director, DESC-R, (703) 767-9450

Subject: Draft Report on Financial Reporting of DLA-Owned Bulk Petroleum Products,
Project No. D2000FJ-0067.007

Recommendation 3: Perform interim procedures to cut off the subsidiary ledger at year-end and account for all transactions in the proper accounting period.

DLA Comments:

Partially concur. The audit report did not show any transactions that had been included in the wrong accounting period. In our opinion, the existing cut-off procedures for the current legacy system that are in place are adequate.

() Ongoing. Estimated completion Date:
(x) Considered Complete.

Action Officer: Richard Sninsky, DESC-R, (703) 767-8455

Approval: Carol O'Leary, Director, DESC-R, (703) 767-9450

Subject: Draft Report on Financial Reporting of DLA-Owned Bulk Petroleum Products,
Project No. D2000FJ-0067.007

Recommendation 4: Ensure that the Defense Fuel Automated Management System replacement system properly accounts for the deficiencies outlined in this report. Specifically the system should:

- a. be date driven to account for all transactions in the proper accounting period, and;
- b. properly account for barge transactions in accordance with DoD Manual 4140.25-M.

DLA Comments:

Partially Concur. These requirements are known and are expected.

() Ongoing. Estimated completion Date:
(x) Considered Complete.

Action Officer: Richard Sninsky, DESC-R, (703) 767-8455

Approval: Carol O'Leary, Director, DESC-R, (703) 767-9450

Audit Team Members

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

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