Audit Report

AUDIT OF MILITARY DEPARTMENT MATERIEL RETURNS TO THE DEFENSE LOGISTICS AGENCY DISTRIBUTION DEPOTS

Report Number 98-179

July 13, 1998

Office of the Inspector General
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Acronyms

DDSP	Defense Depot, Susquehanna, Pennsylvania
DISC	Defense Industrial Supply Center
DLA	Defense Logistics Agency
DSCP	Defense Supply Center Philadelphia
DSCC	Defense Supply Center Columbus
DSCR	Defense Supply Center Richmond
ICP	Inventory Control Point

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

July 13, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Military Department Materiel Returns to the Defense Logistics Agency Distribution Depots (Report No. 98-179)

We are providing this report for information and use. This is the second in a series of reports dealing with the FY 1997 Defense Logistics Agency Working Capital Fund Financial Statements. In preparing the final report, we considered comments from the Director of the Defense Logistics Agency on the draft of this report.

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

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. James L. Kornides at (614) 751-1400, extension 11, e-mail Jkornides@dodig.osd.mil, or Mr. Timothy F. Soltis at (614) 751-1400, extension 13, e-mail Tsoltis@dodig.osd.mil. See Appendix D for the report distribution. The audit team members are listed inside the back cover.

David Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-179 **July 13, 1998**
(Project No. 8FJ-2002.01)

Audit of Military Department Materiel Returns to the Defense Logistics Agency Distribution Depots

Executive Summary

Introduction. This audit was performed as part of our effort to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. This is the second in a series of reports on the FY 1997 Financial Statements of the Defense Logistics Agency (DLA) Working Capital Fund. The first report was our disclaimer of opinion on the FY 1997 Financial Statements of the DLA Working Capital Fund.

DLA records showed that during FY 1997, field organizations returned at least 458,521 DLA-managed items that were valued at about $427 million to the 21 distribution depots.

Audit Objectives. Our overall objective was to evaluate whether field organizations returned DLA-managed items to the distribution depots in accordance with DoD policy. We also evaluated applicable management controls. See Appendix A for a complete discussion of the scope, methodology, and material management controls.

Audit Results. During FY 1997, 114,057 (about 25 percent) of the 458,521 DLA-managed items that Military Department field organizations returned to the 21 distribution depots were not authorized for return by DLA Inventory Control Points. As a result, DLA incurred unnecessary processing costs and lost approximately $2.2 million annually because it did not bill the Military Departments for unauthorized returns. Also, the quality and efficiency of distribution operations were adversely affected.

The recommendations in this report, if implemented, will improve management controls, result in more efficient distribution operations, and improve the reporting of inventory and revenue in the financial statements of the DLA Working Capital Fund. See Part I for a discussion of the audit results.

Summary of Recommendations. We recommend that the Director, DLA, identify the Military Department organizations that are making unauthorized returns to the distribution depots and provide them with additional guidance on DoD policy for materiel returns. We also recommend that the Director, DLA, begin billing the Military Departments for unauthorized returns.

Management Comments. The Director, Defense Logistics Agency, concurred and initiated action to provide additional guidance to the Military Departments, and to resolve the issue of repeat offenders through meetings. If this does not resolve the problem, the Defense Logistics Agency will initiate action to recover costs for unauthorized returns. See Part I for a discussion of management comments and Part III for the complete text of the management comments.

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Part I - Audit Results

Audit Background

Introduction. During the audit of the FY 1997 Financial Statements of the Defense Logistics Agency (DLA) Working Capital Fund, we identified issues pertaining to DLA-managed materiel that Military Department field organizations returned to the distribution depots. This audit was performed in accordance with the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. This is the second in series of reports on the FY 1997 Financial Statements of the DLA Working Capital Fund. The first report provided our disclaimer of opinion on the FY 1997 DLA Working Capital Fund financial statements. The DLA Working Capital Fund includes 21 distribution depots and 5 Inventory Control Points (ICPs).

DLA Distribution Depots. The DLA distribution depots receive newly procured items; make redistributions (move materiel between depots); receive items returned by field organizations; issue materiel to customers; conduct physical inventories; and provide for the care, preservation, and quality control of items in storage. The distribution depots maintain the accountable records for DoD materiel stored at the depots and report their inventory balances to the Military Department and DLA ICPs. The depot inventory balances are reported to the owning DoD Components, which provide them to the Defense Finance and Accounting Service for use in preparing the financial statements.

During the last several years, significant changes have taken place in the distribution of DoD materiel. In FY 1992, distribution depots formerly managed by the Military Departments were consolidated under DLA. The number of distribution depots has decreased from 30 to 21 because of consolidation and base closures. A number of ongoing DoD initiatives are intended to further consolidate depot operations and improve efficiency.

In FY 1997, the 21 distribution depots stored approximately $8.8 billion (96 percent) of the materiel (excluding fuel) that was managed by DLA ICPs and reported on the DLA Working Capital Fund financial statements. The remaining 4 percent of DLA-managed materiel is located at storage facilities that are not operated by distribution depot personnel. As of September 30, 1997, the DLA distribution depots also stored approximately $91 billion of materiel owned by the Military Departments.[1]

DLA Inventory Control Points. The DLA ICPs manage most consumable materiel for DoD. They direct the movement of materiel into and out of the

[1]The $91 billion represents the unadjusted total value of all inventory and other property stored at the 21 DLA distribution depots at the end of FY 1997. It does not equal the total inventory value reported in the Working Capital Fund financial statements of the Military Departments and DLA because different valuation methods are used for financial statement reporting, and because some materiel stored at the depots is reported on the Military Department General Fund financial statements.

distribution depots and pay the depots for those services. The ICPs also pay the depots an annual storage fee based on the type and amount of storage space occupied at the depots. Maintenance organizations, retail storage organizations, and operating units (field organizations) request, through the appropriate ICP, most of the materiel stored at the distribution depots. The ICPs may direct field organizations to return excess materiel to distribution depots if appropriate.

Receipt Process. The materiel receipt process includes the actions that a distribution depot must take to receive, inspect, and store incoming materiel. The primary sources of materiel received by the 21 DLA distribution depots are from procurement, redistribution, and field returns.

Procurement Receipts. A procurement receipt represents materiel that was shipped from a Defense contractor to a distribution depot. An ICP must first determine that a requirement exists for wholesale supplies. The ICP then establishes the necessary contracts, obligates funds, orders materiel, and directs the contractor to ship the materiel to one or more distribution depots for storage.

Redistribution Receipts. A receipt from redistribution occurs when materiel is moved from one distribution depot to another. Many redistribution actions during the last several years have resulted from base closures and the consolidation of depots.

Field Returns. Field returns represent excess materiel returned to a distribution depot by a field organization that no longer needs the materiel. Materiel should only be returned to a distribution depot after the field organization receives disposition instructions from an ICP.

DLA records showed that, during FY 1997, field organizations returned at least 458,521 DLA-managed items, valued at about $427 million, to the 21 distribution depots.

Audit Objectives

The overall objective of the audit was to determine whether the FY 1997 Financial Statements of the DLA Working Capital Fund were presented fairly and in accordance with the Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by the Office of Management and Budget Bulletin Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. We evaluated whether field organizations returned DLA-managed items to the distribution depots in accordance with DoD policy. We also evaluated applicable management controls. See Appendix A for a complete discussion of the scope, methodology, and management controls.

Returns by Field Organizations

During FY 1997, 114,057 (about 25 percent) of the 458,521 DLA-managed items that Military Department field organizations returned to the 21 distribution depots were not authorized for return by DLA Inventory Control Points. The distribution depots accepted the unauthorized returns and processed the materiel into the supply system, because the Military Department field organizations did not follow DoD policy for returning materiel. DLA also did not establish the necessary management controls to detect and prevent unauthorized returns. As a result, DLA incurred unnecessary processing costs and lost approximately $2.2 million annually because it did not bill the Military Departments for unauthorized returns. Also, the quality and efficiency of distribution operations were adversely affected.

Receipt Authorization Process

DoD manual 4000.25-1-M, "Military Standard Requisitioning and Issue Procedures," May 1987, states procedures for exchanging information between field organizations and DoD Component ICPs. The procedures require field organizations to prepare reports showing their excess materiel and to transmit the reports to the ICP that manages the item. The ICP must review the reports of excess and send disposition instructions to the field organization within 30 days. Field organizations are usually directed to return excess materiel to a wholesale storage site such as a distribution depot, retain the excess materiel, or dispose of it according to applicable policies. DoD Regulation 4140.1-R, "DoD Materiel Management Regulation," January 1993, states that ICPs should base their disposition instructions on the costs of processing, holding, and shipping the materiel.

DLA Manual 4140.2, "Supply Operations Manual, Defense Supply Center, Operating Procedures," April 1994, states that the cost of accepting materiel returns into the supply system can be overlooked if the item has been back ordered to fill requisitions from U.S. troops, if recommended buys or purchase requests are outstanding, if the materiel is provided by a diminishing manufacturing source, or if the ICP finds other valid justification for returning the materiel to a distribution depot.

Materiel Returned by Field Organizations

DLA records showed that, during FY 1997, field organizations returned at least 458,521 DLA-managed items, valued at about $427 million, to the 21 distribution depots. The records also showed that 114,057 (almost 25 percent) of the Military Department returns were not authorized by a DLA ICP. An unauthorized return occurs when a field organization returns materiel to a distribution depot without receiving disposition instructions or after being directed by the ICP not to return the materiel.

DLA did not provide detailed transactions for the 114,057 unauthorized returns. However, the Defense Supply Center, Columbus, Ohio (DSCC),[2] gave us details on 12,163 unauthorized returns made by field organizations to the Defense Depot, Susquehanna, Pennsylvania (DDSP).[3] We reviewed the characteristics of the 12,163 items. In addition, we selected a judgmental sample of 50 items to determine whether the items would have been accepted by the ICPs if proper supply procedures had been followed. Appendix A describes the methodology we used.

Characteristics of Unauthorized Returns. We identified the following characteristics of the 12,163 unauthorized returns:

o 4,247 (35 percent) of the items had an extended value of less than $45. DLA requires stricter screening of items valued at $45 or less.

o 2,678 (22 percent) of the items had an extended value of less than $20, which is the minimum cost charged by a distribution depot to process a materiel return.

o 866 (7 percent) of the items were not in condition code A, which identifies materiel that is unused and issuable without qualification.

o 364 (3 percent) of the items were in condition code H, which identifies materiel that has been condemned and cannot be issued.

Little overlap occurred between low-value items (under $45) and items that were not in condition code A. Consequently, 4,860 items (about 40 percent) either had low dollar values or were not in condition code A.

Wholesale Requirements for Unauthorized Returns. We took a judgmental sample of 50 of the 12,163 unauthorized returns to determine whether valid wholesale requirements existed at the time DDSP received the items. Our judgmental sample included high- and low-value items and items returned in good and poor condition. We interviewed DSCC item managers and other DLA personnel about the 50 items, and we reviewed related documents and automated records. Of the 50 items, no justification existed for returning 26 items to the supply system. Item managers expressed concern about the cost of

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[2]DSCC is one of five DLA ICPs that manage consumable items used by the Military Departments. The other DLA ICPs are the Defense Supply Center, Richmond, Virginia; the Defense Industrial Supply Center, Philadelphia, Pennsylvania; the Defense Supply Center, Philadelphia, Pennsylvania; and the Defense Energy Support Center, Fort Belvoir, Virginia.

[3]DDSP is one of 21 DLA distribution depots. It consists of two depots in Mechanicsburg and New Cumberland, Pennsylvania. The two depots were consolidated to form the DDSP.

returning low value items to distribution depots, especially when the cost of the item was lower than the depot's cost to process a receipt. Two examples of unauthorized returns to DDSP follow:

Four oxygen line connectors (National Stock Number 1660-00-225-7292) were returned by an Air Force field organization in condition code H on September 4, 1997. The connectors have a standard unit price of $97.44; however, they had no real value and should have been sent directly to disposal. On the same day that the items were received, DDSP sent them to a Defense Reutilization and Marketing Office for disposal. DSCC paid DDSP $19.56 to process the receipt and $7.25 to process the disposal transaction.

One electrical connector plug (National Stock Number 5935-00-615-2212) was returned to DDSP on September 7, 1997. The value of the plug was $8.50, which is lower than the $19.56 minimum cost to receive an item at a distribution depot. The item manager stated that DSCC had adequate inventory to last for 6 years and was disposing of these items at the same time DDSP received them. In addition, because of the item's low cost, it did not meet the criteria for materiel returns.

Compliance With DoD Policy

Military Department field organizations did not follow DoD policies for returning excess materiel to the distribution depots. They returned excess materiel directly to DLA distribution depots without preparing reports of excess and without receiving disposition instructions from the DLA ICP. The distribution depots processed all materiel returns and billed the ICPs, even if the returns were not authorized.

DLA computer files contained detailed transactions for the 114,057 unauthorized returns made by field organizations. DLA personnel stated that accessing the files required special programming and that other work had higher priority. Therefore, no information was made available to the auditors to determine why field organizations made the unauthorized returns.

Management Controls

DLA did not establish the necessary management controls to identify and prevent unauthorized returns from field organizations. DLA did not track unauthorized returns or charge the Military Departments for the costs of processing unauthorized returns.

Identifying Unauthorized Returns. DLA last reviewed materiel returns in April 1993 when it concluded that 12 percent of all returns to DLA distribution depots were unauthorized, and that field organizations had sent about 58 percent of the unauthorized returns to distribution depots without receiving disposition instructions. For the remaining 42 percent, an ICP had been notified that excess materiel was on hand and had directed the field organization not to return it to a distribution depot. DLA personnel told us that, at the time of the review, DLA management believed that 12 percent was acceptable and assumed that most unauthorized returns were for materiel that was needed at the wholesale level. The assumption was not valid and the problem of unauthorized returns has grown. Unauthorized materiel returns increased from 12 percent in FY 1993 to at least 25 percent in FY 1997.

DDSP began tracking unauthorized materiel returns in June 1997 and during June and July identified 33,429 returns from field organizations. Records showed that 6,641 (almost 20 percent) of the returns were unauthorized. However, no other depot implemented a similar tracking system. DLA was not aware that DDSP was tracking unauthorized returns.

We provided DLA with a list of the 6,641 items for further analysis. DLA concluded that 5,920 (almost 90 percent) of the returns identified by DDSP were not authorized. The status of the remaining 10 percent was indeterminable at the time of the audit. Further analysis by DLA showed that six retail organizations accounted for about 44 percent of the unauthorized returns.

Preventing Unauthorized Returns. The receipt process at the distribution depots is not designed to detect unauthorized returns before they are accepted. The first step is when depot personnel unload the vehicle that contains the returned materiel. If the materiel is properly addressed, the depot accepts the materiel, unloads it, and the carrier departs. Although the distribution depots can use ICP records to identify unauthorized returns, depot personnel told us that it would be time-consuming and costly for them to check the ICP records for each returned item and to reject unauthorized returns at the time of receipt. Therefore, DLA must establish another type of control, such as billing the Military Departments.

Billing Military Departments for Unauthorized Returns. DLA did not have a process for identifying the field organizations that were responsible for the unauthorized returns. For example, DLA spent more than 4 months to process our request to provide summary data on unauthorized returns and to identify the field organizations that made the 114,057 returns. DLA needs to establish a process for identifying and billing the Military Departments for the costs of receipting, packaging, storing, and disposing of unauthorized returns. Proper allocation of charges to the Military Departments will reduce DLA processing costs, increase distribution depot revenue, and motivate field organizations to follow DoD policy for returning materiel.

Financial Impact of Unauthorized Returns

Depot Operating Costs. The distribution depots billed the DLA ICPs for all materiel returns, regardless of whether the returns were authorized. In FY 1997, billing rates ranged from $19.56 to $42.89, depending on whether the materiel required bin, medium, heavy, or hazardous storage. The depots also charged the ICPs for storage of materiel. When materiel was returned in poor condition or represented excess (beyond ICP retention levels), it was usually sent to a disposal facility. Storage costs ranged from $0.48 to $5.16 per square foot, depending on whether covered or uncovered storage was provided, and disposal costs ranged from $7.25 to $51.73 per transaction.

Loss of DLA Revenue. DLA lost revenue because it did not bill the Military Departments for unauthorized returns. Billing the Military Departments with the minimum processing cost of $19.56 for each of the 114,057 unauthorized returns could have generated an additional $2.2 million for the DLA Working Capital Fund, or about $13.2 million over the 6-year Future Years Defense Budget. We did not consider the type of storage required, which could cost as much as $42.89 per receipt. Also, we could not calculate the amount of storage costs associated with the unauthorized returns or estimate how many of the unauthorized returns were sent to disposal.

Operational Impact

Unauthorized returns also adversely affected the quality and efficiency of distribution depot operations.

Potential Problems With Quality. Delivering reliable, high quality materiel to customers is a major goal of the distribution depots.

Item managers at DSCC and other DLA personnel expressed concern about the condition of materiel returned by field organizations and stated that returns presented a potential quality problem. The depots commingled materiel returns with newly procured materiel and issued both to fill customer requests. If items returned to the depots had been opened or not properly cared for while out of the depots' custody, quality could suffer. As indicated above, 866 items, more than 7 percent of the 12,163 unauthorized returns to DDSP, were not in condition code A (unused and issuable without qualification).

The DLA FY 1996 Performance Report reported a 2-percent defect rate for newly procured materiel sent directly from Defense contractors to distribution depots. The defect rate for returns from field organizations was a much higher 12 percent. In August 1996, DDSP began identifying, inspecting, and testing selected DSCC items that DDSP customers identified as having a history of quality problems. The tests showed a 30-percent defect rate for selected materiel returns. Because of the high defect rate, DLA directed its distribution depots to screen all customer returns that were identified as having quality problems.

Process Improvements. Two major goals of the Chief Financial Officer's Financial Management Status Report and the DoD 5 Year Plan are to reengineer DoD business practices and strengthen internal controls. In addition, one goal of the DoD Logistics Strategic Plan for FY 1997 is to improve business processes. The plans outline DoD goals and strategies for improving the operations of DoD support organizations such as the DLA distribution depots. Implementing controls to detect and prevent or significantly reduce unauthorized returns will help DLA to achieve these goals.

Both authorized and unauthorized returns are included in the workloads of distribution depots and are charged to ICPs on Military Interdepartmental Purchase Requests. Unauthorized returns inflate the workloads of distribution depots. As a result, decisions about staffing levels and depot size may be based on inaccurate information. DLA is currently evaluating distribution operations to determine whether size and costs can be further reduced. Valid workload data on materiel returns should assist DLA in that effort.

Recommendations and Management Comments

1. Establish procedures to identify the field organizations that make unauthorized materiel returns.

Management Comments. The Director, Defense Logistics Agency, concurred and took part in changing the DoD supply process, including the Supply Discrepancy Report Regulation, to hold the shipper (field organization) accountable for discrepant materiel return receipts.

2. Provide additional guidance to the field organizations on DoD policies for returning materiel. Specifically, field organizations should be instructed to:

a. Prepare reports listing excess materiel and submit them to the responsible Inventory Control Point.

b. Await disposition instructions from the Inventory Control Point before returning the materiel to the distribution depot.

Management Comments. The Director, Defense Logistics Agency, partially concurred with the recommendation. He stated that the Military Services, not the DLA must provide guidance to their field organizations on DoD Policies for returning materiel. However, he indicated that DLA will inform the Military Services how future unauthorized returns will be handled.

3. Establish procedures to bill the Military Departments for unauthorized returns.

Management Comments. The Director, Defense Logistics Agency, partially concurred with the recommendation. He stated that the DLA will first meet with the organizations that are identified as sending unauthorized returns to the defense depots to discuss the ramifications of what they are doing. Should that fail to correct the problem, DLA will begin to recover its costs for the unauthorized returns through the billing process.

Part II - Additional Information

Appendix A. Audit Process

Scope

Work Performed. During our audit of the FY 1997 Financial Statements of the DLA Working Capital Fund, we reviewed the materiel receiving process at DDSP and the Defense Depot, San Joaquin, California. We obtained information from the DSCC and DLA. We also reviewed the distribution depots' procedures. DLA records showed that, during FY 1997, field organizations returned at least 458,521 DLA-managed items that were valued at about $427 million. See Appendix B for detailed information on unauthorized returns for the Services.

Problems in controls over the receiving process led us to this separate audit of Military Department field organizations returns to the DLA distribution depots. We reviewed policy and procedures for materiel returns, evaluated the depots' billing practices, and assessed the impact of unauthorized returns on depot operations.

Methodology

The DDSP began tracking unauthorized materiel returns on June 1, 1997, and records from June 1 through July 31, 1997, showed that DDSP received 6,641 unauthorized returns of DLA-managed materiel during the 2-month period.

We expanded our work on authorized returns by requesting DLA to provide us with information about all returns of DLA-managed materiel (other than fuel and subsistence items) during FY 1997. DLA records showed that the 21 DLA distribution depots received at least 458,521 returns of DLA managed items. The returns included some returns from DLA and other DoD field organizations that we excluded from our evaluation. The records also showed that 114,057 (almost 25 percent) of the returns from the Military Departments had not been authorized by the DLA ICPs. The data did not include detailed transactions for the 114,057 unauthorized returns. DLA computer files contained detailed transactions, but DLA personnel stated that accessing those files required special programming and that other work had higher priority.

We obtained a computer file from DSCC that listed 12,163 DSCC-managed items returned to DDSP during FY 1997 without proper authorization. We evaluated the data to determine the characteristics of the items returned. We also selected a judgmental sample of 50 of the 12,163 items to determine whether the items would have been accepted by the ICPs if proper procedures had been followed. We interviewed item managers, reviewed policies, and evaluated requirements and stock levels to determine whether the items would have been accepted if DoD procedures had been followed. Our judgmental sample consisted of high- and low-value items and items returned in good and poor condition.

Use of Computer-Processed Data. We used computer-processed data in performing this audit. In response to specific inquiries, DLA provided summary data on the total materiel returns, and DSCC personnel provided detailed data on 12,163 items. We did not evaluate the methodology used by DLA to query its automated systems, and we did not review general or application controls for those systems. We tested the accuracy of the data for the 50 items in our judgmental sample by comparing the automated records to detailed source documents. All 50 items we selected were supported by the detailed records.

DoD-wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, the Department of Defense has established 6 DoD-wide corporate-level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the objective to fundamentally reengineer the Department and achieve a 21st century infrastructure. The goal is to reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

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 Financial Management and Logistics functional area objectives of strengthening internal controls and streamlining the logistics infrastructure. The respective goals are to improve compliance with the Federal Managers' Financial Integrity Act and implement the most successful business practices to reduce inventory to minimally required levels. **(FM 5.3 and LOG 3.1)**

General Accounting Office High Risk Areas. The General Accounting Office has identified several high risk areas in the Department of Defense. This report provides coverage of the Financial Management and Logistics high risk areas.

Audit Type, Dates, and Standards. This financial-related audit was conducted from July 1997 through February 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included such tests of management controls as were considered necessary.

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

Management Control Program Review

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

Scope of Review of the Management Control Program. We reviewed the adequacy of DLA management controls to identify and prevent unauthorized returns from field organizations. We also reviewed management's self-evaluation of those controls.

Adequacy of Management Controls. We identified material management control weaknesses for DLA, as defined by DoD Directive 5010.38. DLA management controls were not adequate to detect unauthorized returns and to prevent them from entering the supply system. The recommendations in the report, if implemented, will help DLA to reduce unauthorized returns. A copy of the report will be provided to the senior DLA official responsible for management controls.

Adequacy of Management's Self-Evaluation. The DLA program manager for materiel returns and other DLA personnel were aware of the problems of unauthorized materiel returns. However, DLA did not establish an assessable unit, establish necessary controls, or report the problem in its self-evaluation of management controls.

Appendix B. Summary of Prior Coverage

Office of the Inspector General, DoD

Inspector General, DoD, report No. 98-179 "Audit Opinion of the Defense Logistics Agency Working Capital Fund Financial Statements for FY 1997" February 27, 1998. The objective was to render an opinion on the financial statements, to determine whether internal controls were adequate, and to determine whether management complied with applicable laws and regulations. We were unable to render an opinion on FY 1997 and 1996 DLA Working Capital Fund Financial Statements because our limited work disclosed additional scope limitations. DFAS was late in providing us with the final version (version 3) of the financial statements, and DLA was late in providing us with the management and legal representation letters and logistics data needed to support the reported inventory balances. Therefore, we could not consider that information in attempting to render an opinion. We also had difficulty gaining access to financial data in the DLA automated systems. Because of significant deficiencies in the accounting systems and internal controls, we were unable to verify the inventory balances on the FY 1997 financial statements.

Appendix C. Schedule of Unauthorized Materiel Returns From the Services

Inventory Control Points

Customer	DSCC	DSCR	DISC	DSCP	Total
Army	23,218	6,950	14,829	3,291	48,288
Navy	21,863	8,350	9,345	2,430	41,988
Air Force	8,220	5,138	6,755	1,900	22,013
Marine Corps	799	306	324	339	1768
Total	**54,100**	**20,744**	**31,253**	**7,960**	**114,057**

Of the 458,521 DLA-managed items that were returned in FY 1997, 114,057 items were not authorized for return by an ICP. The table shows the four DLA ICPs that managed the unauthorized materiel returns received by the distribution depots during FY 1997.

Appendix D. Report Distribution

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Appendix D. Report Distribution

Non-Defense Federal Organizations

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Part III - Management Comments

Defense Logistics Agency Comments

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IN REPLY REFER TO DDAI

MAY 11 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: OIG Draft Report, "*Military Department Materiel Returns to the Defense Logistics Agency Distribution Depots,*" (Project No. 8FJ-2002.01)

This is in response to your March 13, 1998 request. If you have any questions, please contact Ms. Annell Williams, 703-767-6274.

Encl

JEFFREY GOLDSTEIN
Chief (Acting), Internal Review Office

Subject: Audit Report on Military Department Materiel Returns to the Defense Logistics Agency Distribution Depots (Projects No. 8FJ-2002.01)

Finding: During FY 1997, 114,057 (about 25 percent) of the 458,521 DLA managed items that Military Department field organizations returned to the 21 distribution depots were not authorized for return by DLA Inventory Control Points. As a result, DLA incurred unnecessary processing costs and lost approximately $2.2 million annually because it did not bill the Military Departments for unauthorized returns. Also, the quality and efficiency of distribution operations were adversely affected, as was inventory accuracy.

DLA Comments: Military Services who return material to DLA without authorization cause significant problems for the defense depots. That is why it is important for the Services to understand and abide by the policy for the Materiel Return Program (MRP) as described in DOD 4140.1-R, DOD Materiel Management Regulation, Chapter 4.

Recommendation No. 1:
The Director, Defense Logistics Agency establishes procedures to identify the field organizations that make unauthorized materiel returns.

DLA Comments: Concur. Because of this problem, the DOD Supply Process Review Committee has staffed changes to Supply Discrepancy Report (SDR) Regulation, to MILSBILLS and to MILSTRIP, with coordination by all the Military Services and Agencies. The change to MILSTRIP provides a cautionary statement that the shipper will be held accountable for discrepant materiel return receipts, since the process for MRP is described in Chapter 9. The changes to the SDR regulation and MILSBILLS describes the execution of that policy.

a. The MILSTRIP change was staffed as Approved Defense Logistics Management System (DLMS) Change 3, Materiel Returns Discrepancies.

b. The MILSBILLS change was staffed as Interim Change 97-1, Reimbursements for Discrepant Materiel Returns and Shipments.

c. The SDR change was staffed as Approved Supply Discrepancy Reporting (SDR) (Report of Discrepancy (ROD) (U.S.) Change 1, Reporting of Supply Discrepancies.

These changes are intended to focus attention on this issue and to provide a deterrent to discrepant shipments. The new SDR policy requires distribution depots to report receipt of unauthorized returns to the ICP, regardless of condition of the materiel.

Disposition: Action is considered complete.

Recommendation No. 2:

The Director, Defense Logistics Agency provides additional guidance to the field organizations on DOD policies for returning materiel. Specifically, field organizations should be instructed to:

a. Prepare reports listing excess materiel and submit them to the responsible Inventory Control Point.

b. Await disposition instructions from the Inventory Control Point before returning the materiel to the distribution depot.

DLA Comments: Partially concur. It is the *Military Services* who must provide guidance to *their* field organizations on DOD policies for returning materiel. However, DLA Headquarters will write to the Military Services reiterating the policy and advising them that in the future, unauthorized returns will be handled as described above and request the Military Services disseminate this information to the lowest levels within their organizations. In addition, we will direct the DLA field activities to follow the new guidance described in Recommendation No.1 above.

Disposition: Action is ongoing. ECD: Letter will be written by July 31, 1998.

Recommendation No. 3:
The Director, DLA establishes procedures to bill the Military Departments for unauthorized returns.

DLA Comments: Partially concur. Our first attempt will be to resolve the issue of "repeat offenders" via face-to-face meetings. Our Customer Interface Support Group, who has field representatives throughout the world, has agreed to meet with activities which are identified as sending unauthorized returns to the defense depots and to discuss the ramifications of what they are doing. Should that fail to correct the problem, DLA has implemented the policy of recovering costs incurred by the Defense Depots for repackaging, disposal, and similar costs for unauthorized returns based upon documented and validated SDRs.

Disposition: Action is considered complete.

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