

# Inspector General

United States  
Department of Defense



## Controls Over Reconciling Army Working Capital Fund Inventory Records

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### **Acronyms**

AMC	Army Materiel Command
AMCOM	Aviation and Missile Life Cycle Management Command
AR	Army Regulation
AWCF	Army Working Capital Fund
CCSS	Commodity Command Standard System
CECOM	Communications-Electronics Life Cycle Management Command
DSS	Distribution Standard System
IAR	Inventory Adjustment Report
LCMC	Life Cycle Management Command
LMP	Logistics Modernization Program System
TACOM	TACOM Life Cycle Management Command



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
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May 13, 2008

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,  
TECHNOLOGY, AND LOGISTICS  
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Controls Over Reconciling Army Working Capital Fund Inventory Records  
(Report No. D-2008-090)

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

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The comments of the Program Executive Officer, Enterprise Information Systems on Recommendation 4, were not responsive. We request that the Program Executive Officer, Enterprise Information Systems provide additional comments on Recommendation 4, by June 13, 2008.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to [AUDDFS@dodig.mil](mailto:AUDDFS@dodig.mil). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Carmelo G. Ventimiglia at (317) 510-4801, extension 275 (DSN 699-4801) or Mr. Robert J. Ringwald at (317) 510-4801, extension 272 (DSN 699-4801). See Appendix D for the report distribution. The team members are listed inside the back cover.

*Patricia A. Marsh*  
Patricia A. Marsh, CPA  
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## Department of Defense Office of Inspector General

**Report No. D-2008-090**

**May 13, 2008**

(Project No. D2007-D000FI-0061.000)

### **Controls Over Reconciling Army Working Capital Fund Inventory Records**

#### **Executive Summary**

**Who Should Read This Report and Why?** DoD and Army officials responsible for reconciling differences in inventory balances between DoD inventory management systems should read this report. This report discusses weaknesses in guidance for performing reconciliations and controls over the process of reconciling the Army Working Capital Fund (AWCF) inventory balances reported in the Distribution Standard System to the Army's supply records.

**Background.** The Defense Distribution Center, which stores most AWCF inventory at 26 worldwide distribution centers, and the Army Life Cycle Management Commands (LCMCs), which manage AWCF inventory, rely on different inventory management systems that do not share the same inventory records. Consequently, the Defense Distribution Center and the LCMCs annually perform a 100-percent reconciliation of inventory records. In addition, the distribution centers and the LCMCs reconcile inventory records daily, as part of end-of-day business processes, for items having supply activity during the business day. The Distribution Standard System, the materiel management system for the distribution centers, generates a computer file of the asset balances for the AWCF inventory managed by the LCMCs. The LCMCs match the Distribution Standard System reported inventory balances with inventory balances recorded in the AWCF supply systems. When differences exist between systems, the AWCF supply systems automatically create an inventory accounting adjustment gain or loss transaction to adjust inventory balances to agree with those recorded in the Distribution Standard System. The AWCF supply systems generate an Inventory Adjustment Report that identifies all inventory accounting adjustments processed during the month. LCMC inventory personnel are responsible for researching the inventory accounting adjustments and processing any corrections resulting from erroneous, missing, or duplicate supply transactions. The LCMCs are also responsible for working with the distribution centers to isolate causes of record imbalances to maintain transaction-level integrity.

**Results.** The LCMCs did not adequately review inventory accounting adjustments or correct the erroneous, missing, or duplicate supply transactions causing the discrepancies in inventory balances recorded in the Distribution Standard System and the AWCF supply systems. Not reviewing and correcting adjustments results in inaccurate inventory records; distorted reports that inventory managers use to make decisions to buy, repair, and excess materiel; and unreliable and inaccurate financial reports used to measure the performance of the AWCF Supply Management, Army activity group. The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics should revise the guidance and criteria for performing the annual and end-of-day inventory reconciliations in DoD 4000.25-2-M, "Military Standard Transaction Reporting and Accounting Procedures." The Office of the Deputy Chief of Staff for Logistics (Army G-4) needs to



update Army Regulations 740-26, "Storage and Supply Activities, Physical Inventory Control," and 735-5, "Property Accountability, Policies and Procedures for Property Accountability," based on the revised guidance in DoD 4000.25-2-M. In addition, the U.S. Army Materiel Command should establish procedures requiring the LCMCs to report the information required to effectively oversee the annual and end-of-day reconciliations of inventory records and address the underlying system and operational issues requiring corrective action. The Army Program Executive Officer, Enterprise Information Systems should change the Logistics Modernization Program system functionality to provide the system capability to reverse inventory accounting gain and loss adjustments created by the inventory reconciliation process. (See the Finding section of the report for the detailed recommendations.)

**Management Comments and Audit Response.** The Deputy Under Secretary of Defense for Logistics and Materiel Readiness, Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics partially concurred and stated that his office would review DoD 4000.25-2-M and require storage activities and materiel managers to reconcile inventory records before conducting the annual physical inventories in September. The Director of Supply, Office of the Deputy Chief of Staff for Logistics (Army G-4) concurred and stated that Army G-4 will update Army Regulations 740-26 and 735-5 based on the revised requirements of DoD 4000.25-2-M. The Director for Internal Review and Audit Compliance, responding for the Commander, U.S. Army Materiel Command, partially concurred with the need to improve oversight of the annual and end-of-day inventory records reconciliations. The Director stated that the LCMCs are analyzing reconciliation data and reporting on actions taken or planned to address system and operational issues causing inventory gain and loss adjustments. The Director partially agreed with the need for all the LCMCs to report on the results of the end-of-day inventory records reconciliations. She stated that the Communications-Electronics LCMC, which uses the Logistics Modernization Program system, would submit quarterly reports on the results of the end-of-day reconciliations. The Director stated that the other LCMCs would start to report the results of the end-of-day reconciliations upon fielding of the Logistics Modernization Program system. In addition, the Director stated that Army Materiel Command would issue interim guidance for performing the annual and end-of-day reconciliations and require the LCMCs to include more detailed guidance in their written operating procedures. We consider management comments responsive. The Director disagreed with the audit conclusion that material internal control weaknesses existed in the inventory reconciliation process.

The Director for Acquisition Management, Army Program Executive Office, Enterprise Information Systems nonconcurred with the recommendation to give the Logistics Modernization Program system the capability to reverse inventory accounting gain and loss adjustments created by the inventory reconciliation process. The Director stated that the system did not allow for the cancellation of standard inventory adjustments, and for audit and security reasons, it is a best business practice not to allow for the cancellation of transactions. We consider the Director's comments nonresponsive. We do not agree with the current process for correcting inventory accounting adjustments. The current process creates an offsetting gain or loss adjustment, which results in an overstatement of both the Gross Cost and the Earned Revenue lines on the Consolidated Statement of Net Cost. The gain or loss transactions should be reversed, not cancelled. We request that the Army Program Executive Officer, Enterprise Information Systems reconsider its position and provide additional comments on the final report by June 13, 2008. 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.

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## Background

The Supply Management, Army activity group of the Army Working Capital Fund (AWCF) buys and manages materiel for sale to Army operating units and other DoD customers. The Army Life Cycle Management Commands (LCMCs), major subordinate commands of the U.S. Army Materiel Command (AMC), are the materiel managers for the Supply Management, Army activity group. LCMC responsibilities include acquisition, stock control, and requisition processing for the inventory of repair parts and supplies used to support Army-managed systems and equipment. In addition, the LCMCs maintain the supply records and are responsible for ensuring that the information in the AWCF supply systems is correct. The LCMCs are:

- Aviation and Missile Life Cycle Management Command (AMCOM), in Huntsville, Alabama, which manages aviation and missile systems along with the supporting equipment;
- Communications-Electronics Life Cycle Management Command (CECOM), at Fort Monmouth, New Jersey, which manages communications and electronics systems; and
- TACOM Life Cycle Management Command (TACOM), formerly known as the Tank and Automotive Command but now simply as TACOM, has organizational activities in Warren, Michigan; Rock Island, Illinois; and Natick, Massachusetts. TACOM-Warren manages combat, automotive, and construction items; TACOM-Rock Island manages weapons and fire control systems; and TACOM-Natick manages ground support items and chemical weapons. TACOM-Rock Island performs the inventory reconciliation function for TACOM-Natick.

The LCMCs use either the Commodity Command Standard System (CCSS) or the Logistics Modernization Program system (LMP) to manage materiel for the Supply Management, Army activity group. CECOM currently operates LMP, and the Army plans to field the LMP at the other LCMCs by the 4th quarter, FY 2010. The AWCF Supply Management, Army activity group reported gross sales of \$10.1 billion in FY 2007. As of September 30, 2007, the net inventory value totaled about \$19.7 billion.

The Defense Distribution Center, which is managed by the Defense Logistics Agency, provides a single, unified materiel management and distribution system for the Military Services and the Defense Logistics Agency. In this role, the Defense Distribution Center operates 26 worldwide distribution centers. The Distribution Standard System (DSS) integrates all the basic distribution center operations of receiving, storage, shipping, inventory, and transportation. The distribution centers maintain the property accountability records for all materiel in storage, regardless of ownership. As of October 3, 2006, AMC reported that 72 percent of the AWCF inventory was stored at distribution centers. The remaining 28 percent of AWCF inventory was stored at war reserve sites and Army-operated storage sites.

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DoD Regulation 4140.1, “DoD Supply Chain Materiel Management Regulation,” May 23, 2003, requires DoD Components to establish a Physical Control Program that includes physical inventories, quality control, accuracy and performance goals, and reconciliation of asset balances. DoD 4000.25.2-M, “Military Standard Transaction Reporting and Accounting Procedures,” chapter 7, “Physical Inventory Control,” January 2006, defines the responsibilities of the storage activities and materiel managers for maintaining physical control and accountability for DoD inventory. Storage activities’ responsibilities include maintaining the inventory accountability records and researching discrepancies between the records and physical counts.<sup>1</sup> In November 2006, we reported that the distribution centers did not complete research of physical inventory discrepancies in a timely manner, retain adequate supporting documentation, or use the proper error codes to identify underlying causes.<sup>2</sup> In this report, we discuss the LCMC process of reconciling the AWCF inventory balances reported by the distribution centers to the balances recorded in the Army’s supply systems.

DoD 4000.25.2-M, chapter 7, states that a fundamental requirement of inventory integrity is to have a total item property record, which includes a single, shared inventory balance maintained by the storage activity. DoD 4000.25.2-M recognizes that this technical capability does not exist and states that reconciliations are required until DoD agencies and Components establish a single, shared inventory balance.

Each January, the distribution centers and LCMCs perform a reconciliation of inventory records for 100 percent of AWCF inventory. In addition, the distribution centers and LCMCs reconcile inventory records daily, as part of end-of-day business processes, for items having supply activity during the business day. DSS, the materiel management system for the distribution centers, generates a computer file of the balances for the AWCF inventory items managed by the LCMCs. The LCMCs initiate the inventory reconciliation process by matching the asset balances shown on the DSS file with asset balances recorded in the AWCF supply systems. When differences exist between systems, the AWCF supply systems automatically create an Inventory Adjustment Gain–Accounting Error (Document Identifier Code D8B) or an Inventory Adjustment Loss–Accounting Error (Document Identifier Code D9B) transaction to adjust asset balances in the Army supply systems to agree with those recorded in DSS.<sup>3</sup> The AWCF supply systems generate an Inventory Adjustment Report (IAR) that identifies all physical inventory adjustments (D8A and D9A transactions) and inventory accounting adjustments (D8B and D9B transactions) processed during

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<sup>1</sup> Discrepancies between the accountable inventory records and physical counts result in recording either an inventory gain transaction (Inventory Adjustment Increase-Physical Inventory, Document Identifier Code D8A) or an inventory loss transaction (Inventory Adjustment Decrease-Physical Inventory, Document Identifier Code D9A.) These transactions also update the inventory balances in the AWCF supply systems. In LMP, an inventory gain transaction is represented by Movement Code 712, and an inventory loss transaction is represented by Movement Code 711.

<sup>2</sup> DoD Inspector General Report No. D-2007-009, “Internal Controls Over Inventory Stored at Defense Logistics Agency Distribution Depots,” November 1, 2006.

<sup>3</sup> For assets in a serviceable condition, the D8B and D9B transactions normally generate a debit or credit to the Inventory Purchased for Resale account-general ledger account code 1521, and an offsetting debit or credit to either the Other Gains account-general ledger account code 7190 or the Other Losses account-general ledger account code 7290.

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the month because of the automated reconciliations. DoD 4000.25-2-M assigns distribution centers the responsibility for researching the physical inventory adjustments. As part of the annual and end-of-day reconciliations, LCMC inventory technicians are responsible for researching the inventory accounting adjustments and processing any corrections resulting from erroneous, missing, or duplicate supply transactions. The LCMCs are also responsible for working with the distribution centers to isolate causes of record imbalances to maintain transaction-level integrity. The annual and end-of-day inventory reconciliations are essential controls to ensure that the inventory records used by the LCMCs for logistics management and financial accounting and reporting agree with the property accountability records maintained by the distribution centers.

## **Objective**

Our audit objective was to evaluate controls over the process of reconciling the AWCF inventory balances reported in DSS to the Army's supply records. See Appendix A for a discussion of the scope and methodology. See Appendix B for prior coverage related to the objective.

## **Review of Internal Controls**

We identified material internal control weaknesses for the Army as defined by DoD Instruction 5010.40, "Managers' Internal Control Program (MIC) Procedures," January 4, 2006. AMC did not have effective internal controls to ensure that the LCMCs adequately reviewed and corrected inventory accounting adjustments resulting from the annual and end-of-day reconciliations. In addition, Army Regulation (AR) 740-26, "Storage and Supply Activities, Physical Inventory Control," March 12, 2003, contained unclear and incomplete guidance on the requirements for reconciling inventory balances. Finally, LMP did not properly reverse gain and loss adjustments. The January 2007 annual reconciliation of AWCF inventory balances resulted in 3,679 inventory accounting adjustments with a total dollar value of \$280.6 million. The lack of effective internal controls can result in inaccurate inventory records that distort the reports that inventory managers use to make decisions to buy, repair, and excess materiel. Furthermore, the lack of effective internal controls undermines the reliability and accuracy of the financial reports used to measure the performance of the AWCF Supply Management, Army activity group.

Implementing Recommendations 2., 3., and 4. will improve procedures for reconciling the AWCF inventory records. A copy of the report will be provided to the senior Army official responsible for internal controls.

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## **Army Working Capital Fund Inventory Accounting Adjustments**

The LCMCs did not adequately review inventory accounting adjustments resulting from discrepancies between the inventory balances recorded in DSS and in AWCF supply systems. Specifically, the LCMCs did not:

- follow consistent criteria in selecting the inventory accounting adjustments to review;
- review adjustments in a timely manner;
- correct erroneous, missing, or duplicate supply transactions;
- retain adequate supporting documentation;
- track and analyze supply transaction errors to identify the underlying causes for the inventory accounting adjustments; or
- document management oversight and approval.

These conditions occurred because DoD 4000.25-2-M and AR 740-26 contained unclear and incomplete guidance on the requirements for performing the annual and end-of-day reconciliations of inventory balances. In addition, AMC did not effectively monitor the LCMC inventory reconciliations, and the LCMCs did not have effective procedures for or controls over selecting, reviewing, correcting, documenting, analyzing, and approving inventory accounting adjustments. Furthermore, LMP did not properly reverse gain and loss adjustments. Inaccurate inventory records in the Army supply systems distort the reports that inventory managers use to make decisions to buy, repair, and excess materiel, and impact the reliability and accuracy of the financial reports used to measure the performance of the AWCF Supply Management, Army activity group.

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## Criteria

DoD 4000.25-2-M requires annual and end-of-day inventory reconciliations that compare the Defense Distribution Center inventory balances recorded in DSS with the LCMC asset balances recorded in the AWCF supply systems. The purpose of the annual reconciliation is to identify and correct the following situations:

- quantity discrepancies;
- an inventory record in the AWCF supply systems with no matching DSS storage record;
- a DSS storage record with no matching inventory record in the AWCF supply systems; and
- common elements of data, such as unit of issue and controlled inventory item code that do not match.

DoD has established an accuracy goal of 97 percent for the annual inventory reconciliation between the inventory balances recorded in DSS and AWCF supply systems.

According to DoD 4000.25-2-M, the distribution centers are responsible for researching the causes of physical inventory adjustments (D8A and D9A transactions) while the LCMCs are responsible for reviewing the inventory accounting adjustments (D8B and D9B transactions). As part of the annual reconciliation, inventory materiel managers at the LCMCs are required to research the causes of inventory accounting adjustments meeting the following criteria:

- all classified and sensitive items regardless of dollar value,
- pilferable and certain controlled items exceeding \$2,500, and
- all adjustments with an extended value (quantity multiplied by unit cost) greater than \$16,000 or greater than a 25-percent unit variance with a total extended value greater than \$5,000.

The purpose of the end-of-day reconciliation is to match all active records and update the on-hand balances. LCMCs should also work with the distribution centers to isolate causes of record imbalances to maintain transaction-level integrity.

Inventory accounting adjustments are often the result of duplicate and missing supply transactions. The LCMCs are responsible for researching Army supply systems inventory records and, if needed, the DSS inventory records to resolve the discrepancies and correct the Army supply systems records. The LCMCs can request that a distribution center perform a physical inventory if research of the inventory records fails to resolve the discrepancy. DoD 4000.25-2-M requires

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that the materiel manager retain the supporting documentation for researching inventory adjustments for at least 2 years. The LCMCs are also required to collect and maintain performance data on the number and dollar value of accounting adjustments processed during the annual and daily inventory reconciliations.

AR 740-26, “Storage and Supply Activities, Physical Inventory Control,” March 12, 2003, requires the LCMCs to perform daily and annual reconciliations between the inventory balances reported by the storage activities and the asset balances reported by the LCMCs. Appendix G, “Minimum Research Requirements for Potential or Actual Physical Inventory Adjustments,” lists the criteria for performing causative research for inventory adjustments as outlined in DoD 4000.25-2-M. However, AR 740-26 states that the criteria in Appendix G apply only to adjustments made by Army storage activities to the official accountable property records. In addition, AR 735-5, “Policies and Procedures for Property Accountability,” February 28, 2005, requires AMC supply distribution activities to perform causative research for potential inventory losses greater than \$25,000 before processing an inventory adjustment.

## Scope of Inventory Accounting Adjustments

The annual and end-of-day inventory reconciliations between DSS and Army supply systems resulted in a substantial number and dollar value of inventory accounting adjustments. The annual inventory reconciliation, based on inventory balances as of January 2007, resulted in 3,679 adjustments to AWCF asset balances. The adjustments caused inventory gains and losses totaling \$280.6 million (absolute value). The table on the next page contains a breakout of the AWCF inventory accounting adjustment gains and losses, by LCMC, provided by the LCMCs.<sup>4</sup> It also shows the overall inventory reconciliation accuracy rate reported on the 309 Report, “Location Audit Discrepancy Summary Listing.”<sup>5</sup>

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<sup>4</sup> The annual reconciliation included AWCF inventory assets and major end items such as tanks, vehicles, aircraft, and communication equipment purchased using Army procurement appropriation funds. At our request, the LCMCs queried Army supply systems to identify the inventory accounting adjustments related to AWCF assets and major end items. The dollar value of inventory gains and losses and the number of adjustments shown in the table include only AWCF inventory assets.

<sup>5</sup> The 309 Report, “Location Audit Discrepancy Summary Listing,” provides a summary of total inventory gains and losses and calculates the record accuracy rate. The report consolidates the inventory reconciliation results for both AWCF assets and major end items.

**AWCF Totals for the January 2007 Reconciliation**  
(\$ millions)

<u>LCMC</u>	<u>Total Gains</u>	<u>Total Losses</u>	<u>Gross Amount</u>	<u>Number of Adjustments</u>	<u>Accuracy Rate</u>
AMCOM-Aviation	\$ 51.5	\$ 88.2	\$139.7	612	96%
AMCOM-Missile	8.2	5.4	13.6	529	95%
TACOM-Warren	14.1	25.8	39.9	315	96%
TACOM-Rock Island	5.8	9.5	15.3	224	98%
TACOM-Natick	1.1	0.7	1.8	56	94%
CECOM	36.6	33.7	70.3	1,943	94%
<b>Total</b>	<b>\$117.3</b>	<b>\$163.3</b>	<b>\$280.6</b>	<b>3,679</b>	<b>--</b>

Only TACOM-Rock Island met and exceeded the 97-percent inventory accuracy goal prescribed by DoD 4000.25-2-M.

Like the annual reconciliation of inventory balances, the end-of-day reconciliations generated a significant number of inventory gain and loss adjustments. The LCMCs did not track the number and dollar value of adjustments resulting from the daily inventory reconciliations. To gain information on these inventory accounting adjustments, we obtained and summarized the March 2007 IAR for assets stored at the distribution centers. During March 2007, the LCMCs processed a total of 6,464 adjustments worth almost \$1.7 billion. The IAR included inventory accounting adjustments affecting both AWCF assets and major end items purchased and accounted for by the Army General Fund.

## Review of Inventory Accounting Adjustments

The audit focused on the inventory accounting adjustments that resulted from the January 2007 annual reconciliation of the AWCF asset balances recorded in DSS and the balances recorded in the Army supply systems. We selected a judgmental sample of 62 of the 3,679 adjustments, valued at \$132.3 million, to evaluate the processes used by the LCMCs for reviewing and correcting inventory accounting adjustments. The sample included 42 adjustments processed by LCMCs that used CCSS (AMCOM, TACOM-Warren, and TACOM-Rock Island) and 20 adjustments processed by CECOM, which used LMP. We focused more on



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adjustments processed by CECOM because LMP is the Army's system that will replace CCSS. We reviewed the six sample items that the LCMCs had researched prior to our site visits from January through April 2007. For the 56 sampled adjustments that the LCMCs had not reviewed prior to our site visits, we requested that the inventory personnel complete their research and corrective actions and provide us with their information.

Inventory personnel at the LCMCs did not perform a complete and adequate review of inventory accounting adjustment transactions made to reconcile Army supply systems inventory balances to those recorded in DSS. Inventory managers at all the LCMCs stated that available resources limited their reviews of inventory accounting adjustments. The inventory personnel used the IAR to select transactions for review and analysis. By reviewing transaction data in Army supply systems and DSS, inventory personnel could normally identify the erroneous, missing, or duplicate supply transactions causing the accounting gain or loss adjustment. However, the LCMC procedures for selecting, reviewing, correcting, documenting, analyzing, and approving inventory accounting adjustments did not ensure accurate inventory and financial records.

**Selecting.** The LCMCs did not follow consistent criteria in selecting the inventory adjustment transactions from the IAR to review. LCMCs selected adjustments for review in the following ways.

- CECOM personnel reviewed all physical inventory gain and loss adjustments valued at more than \$25,000 and a limited sample of inventory accounting adjustments, primarily adjustments valued at more than \$1 million. CECOM personnel stated that they considered it more important to validate the physical inventory gains and losses processed by the distribution centers than to research the accounting gains and losses resulting from the reconciliation process.
- TACOM-Warren and TACOM-Rock Island personnel reviewed a judgmental sample of both physical inventory adjustments and inventory accounting adjustments valued at more than \$25,000.
- AMCOM reviewed inventory accounting gain adjustments valued at more than \$50,000 and loss adjustments valued at more than \$25,000. In addition, AMCOM personnel reviewed atypical physical inventory gain and loss adjustments.

Inventory technicians at the LCMCs generally focused on inventory adjustments greater than \$25,000 to review, as prescribed by AR 735-5. However, the criteria in AR 735-5 apply to accountable property officers at AMC supply distribution activities, not to inventory technicians at the LCMCs. In addition, AR 735-5 is in direct conflict with DoD 4000.25-2-M, which requires that all storage activities review physical inventory losses valued at more than \$16,000. The LCMCs should select for review all adjustments meeting the criteria identified in DoD 4000.25-2-M. If resource constraints prevent the review of adjustments meeting established criteria, the LCMCs should focus available resources on researching and correcting inventory accounting gain and loss adjustments that most affect the accuracy of supply management and financial data.

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**Reviewing.** The LCMCs did not review inventory accounting adjustments in a timely manner. DoD 4000.25-2-M requires storage activities to complete causative research within 45 days of posting a physical inventory adjustment but does not establish a timeframe for researching inventory accounting adjustments processed by the LCMCs. At the time of our visits, the LCMCs had reviewed only 6 of the 62 inventory accounting adjustments sampled. The LCMCs reviewed the remaining 56 adjustments at our request from April through August 2007. We requested the results of their research more than 3 months after the January 2007 annual inventory reconciliation. The LCMCs had not established a timeframe for researching and correcting inventory accounting adjustments selected for review from the monthly IAR. In addition, TACOM-Warren and TACOM-Rock Island did not track the time taken to complete the review of the selected inventory adjustments. At AMCOM, personnel stated that they were 9 months behind in researching some monthly IARs. CECOM generally completed the reviews of selected adjustments within 2 or 3 months. Timely review of inventory adjustments decreases the volume of records that the LCMC personnel must research to identify the erroneous or missing supply transactions that caused the adjustments and expedites the recording of the correcting transactions.

**Correcting.** For those inventory accounting adjustments we selected for our review, AMCOM, TACOM-Rock Island, and TACOM-Warren corrected the erroneous, missing, or duplicate transaction documents that caused the discrepancies between DSS and CCSS inventory balances. Following normal business practices, personnel at AMCOM, TACOM-Rock Island, and TACOM-Warren researched the 42 inventory accounting adjustments sampled and determined that 12 adjustments resulted from offsetting gains and losses. For two additional transactions, the resulting inventory adjustment from the reconciliation was correct. In both cases, the CCSS supply records were accurate. For the remaining 28 inventory accounting adjustments, personnel reversed the gain or loss adjustment and posted the correct supply transaction. However, for the 20 CECOM adjustments sampled, technicians researched and identified the transactions that caused the inventory accounting adjustments, but—following normal business practices—did not correct LMP. CECOM inventory technicians reviewed the balance in LMP to ensure that it matched the balance in DSS, but did not correct the LMP transaction history because doing so was not required as a part of the standard operating procedures. The following two examples demonstrate the significance of ensuring accurate information in the Army supply systems.

**CCSS Adjustment.** CCSS posted an inventory accounting adjustment loss of \$118,080 on January 11, 2007, for a TACOM-Warren-managed item. In response to our request for information on the annual reconciliation, inventory technicians researched the adjustment and determined that the distribution center had posted in DSS on December 21, 2006, a reversal of a materiel receipt from a procurement transaction for 180 electrical fuel pumps. However, the reversal transaction did not post in CCSS. The transaction reduced the on-hand asset balance in DSS. On May 11, 2007, the TACOM-Warren inventory technician reversed the \$118,080 inventory adjustment loss and posted in CCSS the original DSS document that reversed the materiel receipt from procurement. If the inventory technicians had not reversed the inventory accounting adjustment and

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posted the materiel receipt reversal transaction, CCSS supply records would have understated the number of electrical fuel pumps due-in from procurement by 180 items. In addition, CCSS financial records would have overstated the Other Losses account—general ledger account code 7290 by \$118,080.

**LMP Adjustment.** LMP posted an inventory accounting adjustment gain of \$1.1 million for 2,000 antennas on January 11, 2007. A comparison of DSS and LMP inventory transaction histories for this CECOM-managed item showed that receipts from procurement transactions for 1,764 antennas on January 5, 2007, and for 236 antennas on January 8, 2007, had posted in DSS but not in LMP. The receipts from procurement transactions increased the on-hand asset balance in DSS above the balance recorded in LMP. Because the inventory technicians did not reverse the inventory accounting gain for the 2,000 antennas recorded in LMP as of January 10, 2007, and post the two materiel receipt transactions in LMP, the inventory supply records continued to overstate antennas due-in from procurement by 2,000. In addition, the inventory technicians did not update the accounting records to reflect an increase in accounts payable and a decrease in undelivered orders.

The LCMCs should thoroughly research inventory accounting adjustments and process correcting transactions to ensure that supply management and financial data are recorded accurately.

**Documenting.** The LCMCs did not follow consistent procedures for retaining documentation to support research performed and corrective actions taken. DoD 4000.25-2-M requires that the inventory manager retain documentation of causative research of inventory accounting adjustments for at least 2 years. At TACOM-Rock Island, the accountable property officer retained the IAR and the CCSS and DSS supply transaction histories supporting the research performed and corrective actions taken for 2 years. Inventory personnel at TACOM-Warren stated that they did not retain the monthly IARs or documentation of causative research for the full 2 years because of limited storage space. At AMCOM, inventory technicians retained copies of the monthly IAR. However, they did not retain the CCSS and DSS supply transaction histories to support research performed and corrective action taken. At CECOM, personnel retained the monthly IAR and supporting documentation, including the review checklist completed by inventory personnel, for 2 years. Documentation of the research performed and corrections made to supply management records provides an audit trail that is essential for management oversight and support for supply adjustment transactions that affect both supply management data and financial reports.

**Analyzing.** The LCMCs did not track and analyze supply errors to identify the underlying causes for the inventory adjustments. Inventory adjustments are normally the result of duplicate, erroneous, and missing supply transactions. An analysis of supply transaction errors is vital to identify operational control failures and system problems that require correction to reduce similar discrepancies in the future. None of the LCMCs had procedures in place to track, analyze, and evaluate the transaction errors that were causing inventory accounting adjustments. Therefore, they did not identify or initiate action to correct the underlying causes of the discrepancies in reported asset balances in the inventory supply records. If LCMC inventory personnel had established a process to track

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and analyze supply transaction errors, personnel could identify and take action to correct common errors and system deficiencies. The LCMCs need to implement a process to track and analyze transaction errors to identify the underlying causes for the inventory adjustments.

**Approving.** The LCMCs did not have adequate management oversight or documentation of the approval of inventory adjustment reviews performed by the inventory technicians. At TACOM-Warren and TACOM-Rock Island, managers did not review or approve the results of the technicians' research of the inventory accounting adjustments and the corrective actions taken. At AMCOM, managers reviewed and approved the monthly IARs that technicians annotated to show that they researched the adjustments and what corrections they made. However, managers did not review supporting documentation. They also approved the IARs months after the adjustments were processed. At CECOM, managers tracked, reviewed, and approved the results of the technician's research of inventory accounting and physical inventory adjustments. However, managers did not require that the technicians correct the erroneous, duplicate, or missing transactions that caused the adjustments. Managers required only that the balance in LMP match the balance in DSS. LCMC managers need to effectively oversee the inventory reconciliation process to ensure that inventory technicians are thoroughly researching adjustments, making corrections, and identifying and addressing underlying causes.

## Controls Over Inventory Accounting Adjustments

The control weaknesses in researching and correcting inventory accounting adjustments occurred because:

- DoD 4000.25-2-M and AR 740-26 did not contain clear and complete guidance on the requirements for reviewing and correcting inventory accounting adjustments resulting from the annual and end-of-day reconciliations of inventory balances;
- AMC personnel had not established a process to effectively monitor the inventory reconciliations performed by inventory technicians at the LCMCs;
- the LCMCs had not implemented adequate operating procedures governing the process and controls for selecting, reviewing, correcting, documenting, analyzing, and approving inventory accounting adjustments; and
- LMP did not properly process reversal adjustments.

**DoD 4000.25-2-M Requirements.** Chapter 7, "Physical Inventory Control," provides guidance on the physical control of and accountability for inventory by storage activities and the reconciliation of the inventory records reported by the storage activity to the inventory records maintained by the national inventory manager. DoD 4000.25-2-M provides storage activities with specific guidance

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and criteria on conducting physical inventories, resolving discrepancies between the accountable records and physical counts, and performing causative research to identify and correct the situations causing recurring errors. However, the guidance in DoD 4000.25-2-M governing the procedures that national inventory managers should follow in reconciling differences between inventory records was insufficient in the areas of causative research, end-of-day adjustments, and the date of the annual reconciliation.

**Causative Research.** As part of the annual inventory reconciliation process, DoD 4000.25-2-M requires that the inventory manager conduct causative research to resolve inventory accounting gain and loss adjustments. Managers should research adjustments to controlled and sensitive items, adjustments with an extended value greater than \$16,000, and adjustments with greater than a 25-percent unit variance with an extended value greater than \$5,000. Discrepancies in the inventory balances reported by the storage activity and the inventory manager are often the result of duplicate transactions, errors, and delays in recording inventory receipts, issues, and adjustments. However, DoD 4000.25-2-M does not clearly define the scope of the inventory manager's responsibility for performing causative research to include whether the inventory manager was to identify and correct the duplicate, erroneous, or missing supply transactions that were causing the inventory accounting adjustments. In addition, DoD 4000.25-2-M does not require the inventory manager to classify, analyze, and evaluate supply transaction errors to determine the underlying system or operational deficiency that was causing incorrect or missing transactions. DoD 4000.25-2-M identifies a timeframe for researching physical inventory adjustments (45 days) but does not state a timeframe for researching inventory accounting adjustments. Failure to adequately research and correct inventory accounting adjustments, including those below the \$16,000 threshold, can result in missing or erroneous issue, receipt, and inventory transfer transactions that distort supply management data and financial records.

**End-of-Day Adjustments.** As part of the end-of-day inventory reconciliation process, DoD 4000.25-2-M states that the national inventory manager will "programmatically"<sup>6</sup> research asset record imbalances for delayed and duplicate transactions. For unresolved mismatched quantities, the national inventory manager will update inventory records to agree with the storage activity's closing on-hand balance. However, DoD 4000.25-2-M did not require the inventory manager to research the resulting inventory accounting gain and loss adjustments resulting from end-of-day reconciliations to identify and correct erroneous, missing, or duplicate supply transactions. Over the course of the year, the number and dollar value of inventory accounting adjustment transactions resulting from the daily reconciliations of asset balances would far exceed the adjustments resulting from the annual reconciliation. DoD 4000.25-2-M should require national inventory managers to follow the same guidance and criteria for researching accounting adjustments resulting from both the annual and end-of-day reconciliations of inventory balances.

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<sup>6</sup> CCSS and LMP have a program application that researches and matches delayed and duplicate supply transactions to reconcile the differences in asset balances reported by the supply activity and the LCMCs. If the program cannot reconcile the differences, it records the D8B inventory accounting gain or D9B inventory accounting loss.

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**Annual Reconciliation Date.** DoD 4000.25-2-M establishes the second Tuesday in January as the date for the annual reconciliation of inventory balances reported by the distribution centers with balances recorded in the LCMC supply systems. The annual reconciliation occurs almost 9 months before September 30 (fiscal year's end). Inventory discrepancies occurring after the second Tuesday in January that inventory technicians do not identify and correct during the end-of-day reconciliation process would remain uncorrected until the annual reconciliation in the subsequent fiscal year. As a result, the fiscal year-end AWCf financial reports would be misstated. To illustrate, in our sample of 62 inventory accounting adjustments valued at \$132.3 million, the FY 2006 financial reports should have included 7 adjustments valued at \$17.4 million. However, the systems did not make the automated adjustments until FY 2007. DoD 4000.25-2-M states that the annual reconciliations are required until DoD agencies and Components establish a single, shared inventory balance. Performing the annual reconciliation closer to fiscal year's end would reduce the time that discrepancies could develop.

The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics should revise DoD 4000.25-2-M to define the guidance and criteria for performing the annual and end-of-day inventory reconciliations. In addition, the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics should require that storage activities and inventory materiel managers perform the annual inventory reconciliations during September, close to fiscal year's end.

**AR 740-26 Requirements.** Army guidance needs to be clear and expand DoD 4000.25-2-M requirements on performing the end-of-day and annual reconciliation of inventory record balances. AR 740-26 describes the same general end-of-day and annual inventory reconciliation processes contained in DoD 4000.25-2-M. However, the regulation states that the criteria in Appendix G for performing causative research, generally for adjustments valued at more than \$16,000 and for all controlled and sensitive inventory items, did not apply to inventory accounting gain and loss adjustments resulting from the annual reconciliation of asset balances. In addition, the regulation requires the LCMCs to report the overall accuracy rate for the annual reconciliation of storage activity and owner inventory balances to AMC. However, the regulation did not require LCMCs to report on the end-of-day reconciliations or the results of research done to correct the erroneous, missing, or duplicate transactions that caused the inventory accounting adjustments. The Office of the Deputy Chief of Staff for Logistics (Army G-4) will need to revise AR 740-26 requirements based on revisions to DoD 4000.25-2-M.

**AMC Oversight.** AMC exercised minimal oversight of the annual and end-of-day reconciliations of inventory records performed by the LCMCs. The Office of the Deputy Chief of Staff for Operations and Logistics (G-3) at AMC coordinated the annual reconciliation of inventory balances recorded by the distribution centers with those recorded by the LCMCs. The LCMCs submitted to AMC copies of the monthly 309 Report, which showed the number of asset lines reconciled and the percentage of lines matching in DSS and the Army supply systems. However, AMC did not require LCMCs to report on reasons for failing to meet the DoD accuracy goal of 97 percent. The LCMCs neither

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provided an analysis of the missing or erroneous supply transactions that caused the inventory accounting gain or loss adjustments nor identified actions taken or recommended to prevent the system and operational issues that caused the missing or erroneous supply transactions. In addition, AMC did not receive data from the LCMCs on the results of the end-of-day inventory reconciliations. AMC needs to establish procedures requiring the LCMCs to report the information required to effectively oversee the annual and end-of-day reconciliations of inventory records and to address the underlying system and operational issues requiring corrective action.

**Standard Operating Procedures.** The LCMCs did not have adequate standard operating procedures for the review of inventory accounting adjustments resulting from the annual and end-of-day reconciliations. Although the LCMCs had standard operating procedures addressing inventory accounting adjustments resulting from the end-of-day and annual reconciliations, the procedures were deficient in several areas. Specifically, LCMCs lacked detailed procedures establishing the:

- criteria for selecting adjustments to review,
- timeframe for completing reviews of inventory accounting adjustments,
- methods for researching adjustments and correcting the underlying supply transactions that caused the discrepancy in asset balances,
- documentation required to support the research performed and corrective actions taken,
- process for tracking and analyzing supply transaction errors to identify and correct trends causing the inventory adjustments, and
- methods for documenting management approval and oversight.

In addition, the LCMCs applied guidance from AR 735-5, which addresses procedures and criteria for reviewing physical inventory adjustments and uses a different dollar threshold for researching adjustments than DoD 4000.25-2-M. A summary of the information contained in the standard operating procedures for individual LCMCs is contained in Appendix C. Pending revisions to DoD 4000.25-2-M and AR 740-26, AMC should issue interim guidance to the LCMCs on developing standard operating procedures for selecting, reviewing, correcting, documenting, analyzing, and approving the inventory accounting adjustments resulting from the annual and end-of-day reconciliations. Furthermore, the Office of the Deputy Chief of Staff for Logistics (Army G-4) will need to revise AR 735-5 requirements for physical inventory adjustments to reflect those in DoD 4000.25-2-M.

**LMP Reversals.** LMP did not provide the capability to reverse inventory accounting gain and loss adjustments that were automatically created as a result of the reconciliation of DSS and LMP asset balances. Rather, LMP required personnel to create an offsetting gain or loss transaction to eliminate the



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system-generated inventory accounting adjustment. For assets in serviceable condition, the offsetting transaction adjusted the supply inventory record and the Inventory Purchased for Resale account-general ledger account code 1521 to the correct balance, and increased either the Other Gains account-general ledger account code 7190 or the Other Losses account-general ledger account code 7290. The inventory personnel could then correct the erroneous, missing, or duplicate transaction that caused the discrepancy between DSS and LMP in the inventory balances.

However, posting an offsetting inventory accounting gain or loss adjustment caused an overstatement of both the Other Gains account-general ledger account code 7190 and the Other Losses account-general ledger account code 7290. As a result, both the Gross Cost line and the Earned Revenue line on the AWCF Consolidated Statement of Net Cost were equally overstated, misrepresenting to the users of the financial statements the actual costs of operation and revenues generated by the AWCF. The Army Program Executive Officer, Enterprise Information Systems should change LMP functionality to provide the system capability to reverse inventory accounting gain and loss adjustments created by the inventory reconciliation process.

## **Conclusion**

The annual and end-of-day inventory reconciliations are essential controls to ensure that the property accountability records maintained by distribution centers agree with the inventory records used by the LCMCs for supply management data and financial reporting. However, the LCMCs did not perform a complete and adequate review of inventory accounting adjustment transactions made to reconcile Army supply systems inventory balances to those recorded in DSS. The lack of effective processes and controls over the inventory reconciliations can result in inaccurate inventory records that distort the reports that inventory managers use to make decisions to buy, repair, and excess materiel, and impact the reliability and accuracy of the financial reports used to measure the performance of the AWCF Supply Management, Army activity group.

The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics needs to revise DoD 4000.25-2-M guidance and criteria for performing the annual and end-of-day inventory reconciliations. In addition, the Office of the Deputy Chief of Staff for Logistics (Army G-4) needs to revise AR 740-26 and AR 735-5 requirements based on revisions to the DoD 4000.25-2-M. AMC needs to establish a process to monitor the LCMCs inventory reconciliations, and the LCMCs need to implement more effective procedures and controls over selecting, reviewing, correcting, documenting, analyzing, and approving inventory accounting adjustments. In addition, the Army Program Executive Officer, Enterprise Information Systems needs to change LMP functionality to process adjustments that reverse inventory accounting gain and loss transactions.

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## Management Comments on the Review of Internal Controls

**Management Comments.** The Director for Internal Review and Audit Compliance, responding for the Commander, AMC, did not agree with the audit conclusion that material internal control weaknesses existed in the process of reconciling the AWCF inventory balances reported in DSS to the Army's supply records. The Director stated that AMC personnel manage the annual inventory reconciliation and provide oversight at a macro level. The Director also stated that, despite the lack of a formal written policy memorandum or Letter of Agreement to enforce AR 740-26 requirements, AMC personnel continuously work and communicate with the LCMCs to ensure performance and reporting of all annual reconciliations of inventory. Specifically, AMC monitors the annual inventory audit schedule and, since November 2007, has required the LCMCs to analyze and report on depots not meeting the DoD accuracy goal of 97 percent.

**Audit Response.** DoD Instruction 5010.40, "Managers' Internal Control Program (MIC) Procedures," January 4, 2006, states that a material weakness is a reportable condition that the head of the DoD Component determines to be significant enough to be reported to the next higher level. The determination of materiality is management's judgment. However, in our opinion, the lack of effective internal controls over the inventory reconciliation process could result in a material misstatement of the financial statements or other financial reports that would not be prevented or detected. The January 2007 annual reconciliation of AWCF inventory balances resulted in 3,679 inventory accounting adjustments with a total value of \$280.6 million. In addition, the end-of-day reconciliations generated a significant number of inventory gain and loss adjustments. Often these inventory accounting adjustments are the result of erroneous, missing, or duplicate supply transactions. If the transactions are not reversed and the correct supply transactions posted, supply records may report invalid due-ins from procurement and depot repair, and financial reports may misstate the value of accounts payable and undelivered orders. At the time of the audit, AMC did not require the LCMCs to summarize and report on the underlying causes identified for not achieving the DoD accuracy goal or to identify corrective actions taken or recommended. In addition, the annual audit schedule and associated instructions did not contain any detail about how to perform the reconciliations, and Headquarters AMC personnel did not perform a detailed review of the 309 Reports received from the LCMCs.

## Recommendations, Management Comments, and Audit Response

**1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics revise DoD 4000.25-2-M guidance for performing the annual and end-of-day reconciliations of the storage activity's inventory records to the national inventory manager's records. Specifically:**

**a. Define the national inventory manager's responsibility for performing causative research to include identifying and correcting the**

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**duplicate, erroneous, or missing supply transactions causing the inventory accounting gain or loss adjustments.**

**b. Require national inventory managers to classify, analyze, and evaluate supply transaction errors to determine and correct the underlying system or operational deficiencies causing the errors.**

**c. Establish a timeframe for completing causative research of inventory accounting adjustments and processing any correcting transactions.**

**d. Require the national inventory managers to follow the same guidance and criteria for researching accounting adjustments resulting from both the annual and the end-of-day inventory reconciliations.**

**e. Require storage activities and inventory materiel managers to perform the annual inventory reconciliations during September, close to fiscal year's end.**

**Management Comments.** The Deputy Under Secretary of Defense for Logistics and Materiel Readiness, Office of the Deputy Secretary of Defense for Acquisition, Technology, and Logistics partially concurred and stated that by September 30, 2008, his office would review guidance in DoD 4000.25-2-M for performing annual and end-of-day reconciliations. However, the Deputy Under Secretary stated that scheduling the annual inventory records reconciliation for all DoD agencies and Components during September would not allow the required 45 days for correcting errors before fiscal year's end. As an alternative to our recommendation, the Deputy Under Secretary recommended that the storage activities and inventory materiel managers perform the annual reconciliation of inventory records before storage activities perform their annual physical inventories. The storage activities schedule the annual physical inventories close to the fiscal year's end to comply with the Chief Financial Officers Act.

**Audit Response.** Management comments are responsive and meet the intent of the recommendation. Performing the annual inventory records reconciliation before the physical inventories and close to fiscal year's end would reduce the time that discrepancies could develop between asset balances reported by the storage activities and balances recorded in the DoD agencies' and Components' supply systems.

**2. We recommend that the Deputy Chief of Staff for Logistics (Army G-4):**

**a. Update Army Regulation 740-26 based on the revised DoD 4000.25-2-M requirements for performing the annual and end-of-day reconciliations of inventory records.**

**b. Revise Army Regulation 735-5 criteria for researching physical inventory adjustments to agree with DoD 4000.25-2-M.**

**Management Comments.** The Director of Supply, Office of the Deputy Chief of Staff for Logistics (Army G-4), concurred and stated that Army G-4 will update

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ARs 740-26 and 735-5 to agree with the revised requirements of DoD 4000.25-2-M. Army G-4 will incorporate the DoD 4000.25-2-M revisions in the next published update of ARs 740-26 and 735-5.

**Audit Response.** The Director of Supply, Office of the Deputy Chief of Staff for Logistics (Army G-4) comments are responsive and meet the intent of the recommendation.

**3. We recommend that the Commander, U.S. Army Materiel Command:**

**a. Implement procedures to improve oversight of the annual and end-of-day inventory records reconciliations by requiring the Army Life Cycle Management Commands to:**

**(1) Include with the 309 Report a summary analysis of the underlying causes identified for not achieving the DoD accuracy goal on the annual reconciliation of inventory records.**

**(2) Identify actions taken or recommended to address the system and operational issues causing the erroneous, missing, and duplicate supply transactions that result in inventory accounting gain and loss adjustments.**

**(3) Accumulate and report quarterly the total number and dollar value of inventory accounting gain and loss adjustments (D8B and D9B transactions) resulting from the end-of-day inventory records reconciliations.**

**Management Comments.** The Director for Internal Review and Audit Compliance, responding for the Commander, AMC, partially concurred and stated that the LCMCs started in November 2007 to analyze and report on depots not meeting the DoD accuracy goal of 97 percent. In addition, actions are ongoing to address system and operational issues affecting inventory gain and loss adjustments. The Director stated that the LCMCs promptly review and implement cost-effective trouble tickets, engineering change requests, operational system changes, and process-improvement recommendations. The Director partially concurred with requiring all LCMCs to report quarterly results of the end-of-day reconciliations. The Director stated that LMP has the capability to report information on the end-of-day reconciliations, and CECOM will accumulate and report quarterly the results of the inventory reconciliations. AMC will require the other LCMCs to submit quarterly reports when the Army fields LMP to the other LCMCs, starting with AMCOM in March 2009.

**Audit Response.** Management comments are responsive. Accumulating and reporting information on inventory accounting gain and loss adjustments will focus attention on system and operational issues that could adversely affect Army plans to improve logistical operations and financial management.

**b. Pending revisions to DoD 4000.25-2-M and Army Regulation 740-26, issue interim guidance to the Army Life Cycle Management**

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**Commands for performing the annual and end-of-day reconciliations of inventory records. Specifically:**

**(1) Establish standard criteria for selecting adjustments to research. If available resources constrain the review of adjustments, require the Army Life Cycle Management Commands to focus on the inventory accounting gain and loss adjustments that most affect the accuracy of supply management and financial data.**

**(2) Identify a standard timeframe for completing research of inventory accounting adjustments.**

**(3) Require the Army Life Cycle Management Commands to include in their operating procedures detailed guidance for:**

**(a) researching adjustments and correcting the underlying supply transactions that caused the discrepancy in asset balances;**

**(b) documenting the causative research performed and corrective actions taken, and retaining supporting documentation;**

**(c) tracking and analyzing supply transaction errors to identify the root cause of the inventory adjustments; and**

**(d) documenting management approval and oversight.**

**Management Comments.** The Director for Internal Review and Audit Compliance, responding for the Commander, AMC, concurred and stated that AMC will develop and issue guidance to the LCMCs on performing reconciliations of inventory records. The guidance will include standard criteria for selecting adjustments to review and a timeframe for completing the reviews. AMC will instruct the LCMCs to develop written operating procedures that include the recommended detailed guidance. The estimated completion date is September 30, 2008.

**Audit Response.** The Director for Internal Review and Audit Compliance comments are responsive and meet the intent of the recommendation.

**4. We recommend that the Army Program Executive Officer, Enterprise Information Systems change the Logistics Modernization Program functionality to provide the system capability to reverse inventory accounting gain and loss adjustments created by the inventory reconciliation process.**

**Management Comments.** The Director for Acquisition Management, Program Executive Office, Enterprise Information Systems nonconcurred and stated that LMP does not allow for the cancellation of standard inventory adjustments. Additionally, for audit and security reasons, it is a best business practice not to allow cancellation of standard inventory adjustments of goods movements.

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**Audit Response.** Management comments are not responsive. We did not recommend that the Army change LMP functionality to allow cancellation of an inventory accounting adjustment. The intent of our recommendation is to provide LMP users the capability to reverse inventory accounting gain and loss adjustments rather than follow the current practice of creating an offsetting gain or loss transaction. Posting an offsetting inventory accounting gain or loss adjustment caused an overstatement of both the Other Gains account-general ledger account code 7190 and the Other Losses account-general ledger account code 7290. Reversing a system-generated accounting adjustment transaction would adjust the Other Gains and Other Losses accounts to the correct balance and provide LMP users and auditors a complete history of all transactions affecting the system-generated inventory accounting adjustment. This capability exists in other systems. The Enterprise Business System, the logistics and financial management system used by the Defense Logistics Agency, incorporated additional codes that identify adjustments requiring research and allow the user to reverse inventory accounting gain or loss adjustments. From a DoD-wide perspective, this difference in handling adjustments causes an inconsistency in the reporting of financial information by the DoD Components. If LMP will not permit the reversal of the standard inventory accounting gain and loss adjustment transactions (technically referred to as SAP inventory movement types 711 and 712), the Program Executive Officer, Enterprise Information Systems should incorporate additional codes into LMP that would identify inventory accounting adjustments and allow users to reverse the adjustments. We request that the Army Program Executive Officer, Enterprise Information Systems reconsider its position and provide additional comments on the final report.

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## Appendix A. Scope and Methodology

We conducted this audit from November 2006 through December 2007 in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We reviewed the guidance and controls over the process of reconciling the AWCf inventory balances reported in DSS to those in the Army's supply records. We reviewed the consistency and completeness of guidance contained in DoD 4000.25.2-M, AR 735-5, and AR 740-26. In addition, we interviewed representatives from the Defense Logistics Agency, Office of the Deputy Chief of Staff for Logistics (Army G-4), and AMC to discuss and clarify regulatory guidance on the inventory reconciliation process. We also interviewed AMC personnel in the Office of the Deputy Chief of Staff for Operations and Logistics (G-3) to determine what process they used to monitor the inventory reconciliations performed by materiel managers at their subordinate LCMCs. We also obtained and analyzed the reports received by AMC on the results of the January 2007 reconciliations of inventory balances performed by the LCMCs.

We reviewed the LCMC standard operating procedures and interviewed personnel to identify the procedures and controls the LCMCs used to select, review, correct, document, analyze, and approve inventory accounting adjustments. We obtained and summarized the number and dollar amounts of inventory accounting adjustments resulting from the January 2007 annual reconciliation and the end-of-day reconciliations processed during March 2007. We selected a judgmental sample of 62 inventory accounting adjustments valued at \$132.3 million from the January 2007 reconciliation to evaluate the four LCMC processes for reviewing and correcting adjustments. We focused on the inventory accounting adjustments because, according to DoD 4000.25.2-M, the LCMCs are responsible for researching the causes for them. In addition, we coordinated with the Army Program Management Office, LMP to determine how LMP processed adjustments that reverse inventory accounting gain and loss transactions.

**Use of Computer-Processed Data.** We used logistical and accounting data generated by DSS, CCSS, and LMP to perform this audit. We did not test the general and application controls in the systems and did not make any conclusion about the reliability of the data. As discussed in the finding, inventory accounting adjustments were often the result of erroneous, missing, or duplicate transactions that caused discrepancies between DSS and either CCSS or LMP. In addition, LMP lacked the capability to reverse inventory accounting gain and loss adjustment transactions correctly. Although we did not perform a formal reliability assessment of computer-processed data, we did not find errors that would preclude the use of the computer-processed data from meeting the audit objective or that would change the conclusions in the report.



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**Government Accountability Office High-Risk Areas.** The Government Accountability Office (GAO) has identified several high-risk areas in DoD. This report provides coverage of the DoD Approach to Business Transformation, Financial Management, and Supply Chain Management high-risk areas.

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## **Appendix B. Prior Coverage**

During the last 5 years, GAO, Department of Defense Inspector General (DoD IG), and the Army Audit Agency (AAA) have issued seven reports discussing Army inventory and Army inventory systems. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>. AAA reports are restricted to military domains and GAO. They can be accessed at <https://www.aaa.army.mil/reports.htm>.

### **GAO**

Report No. 06-983T, “DOD’s High Risk Areas: Challenges Remain to Achieving and Demonstrating Progress in Supply Chain Management,” July 25, 2006

Report No. 06-512, “Defense Inventory: Actions Needed to Improve Inventory Retention Management,” May 2006

Report No. 06-209, “Defense Inventory: Army Needs to Strengthen Internal Controls for Items Shipped to Repair Contractors,” December 2005

Report No. 05-775, “Defense Logistics: DOD Has Begun to Improve Supply Distribution Operations, but Further Actions Are Needed to Sustain These Efforts,” August 2005

Report No. 04-615, “DOD Business Systems Modernization: Billions Continue to be Invested With Inadequate Management Oversight and Accountability,” May 2004

### **DoD IG**

Report No. D-2007-009, “Internal Controls Over Inventory Stored at Defense Logistics Agency Distribution Depots,” November 1, 2006

### **AAA**

Report No. A-2007-0205-FFM, “Logistics Modernization Program System Federal Financial Management Improvement Act of 1996 Compliance-First Deployment Functionality,” September 7, 2007

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## **Appendix C. Life Cycle Management Command Standard Operating Procedures**

### **TACOM**

Inventory personnel at TACOM-Warren and TACOM-Rock Island developed detailed operating procedures for researching and correcting supply transactions rejected during the daily CCSS process cycles and for resolving differences in the supply transactions reported as processed in DSS and CCSS. In addition, TACOM personnel developed limited procedures for performing the annual reconciliation of inventory balances recorded in DSS and CCSS. The procedures required that the inventory technicians review all inventory accounting gain and loss adjustments, reverse incorrect adjustments, and record the correct supply transactions.

However, the operating procedures did not contain detailed instructions on how to review, reverse, and record the correct supply transactions, nor establish timeframes for completing the reviews and retaining supporting documentation. In addition, the procedures did not address analyzing supply transaction errors to identify the root causes for the inventory adjustments and methods for documenting management oversight and approval. Further, TACOM operating procedures did not address reviewing the monthly IAR and the inventory accounting adjustments resulting from the end-of-day reconciliations.

### **AMCOM**

The standard operating procedures developed by AMCOM did include guidance for reviewing inventory accounting adjustments identified on the monthly IAR. The procedures established criteria for selecting adjustments to review and included general guidance on researching accounting gain and loss adjustments, reversing incorrect adjustments, and correcting supply transaction records. In addition, the procedures contained instructions requiring inventory technicians to annotate on the IAR the corrective actions taken, and they required that the team leader, supervisor, and accountable property officer review the annotated IAR. However, the operating procedures did not require technicians to maintain supporting documentation or research reversals and offsetting gain and loss adjustments.\* In addition, the guidance did not state a timeframe for researching adjustments or require inventory personnel to track and analyze supply transactions to identify underlying causes for the inventory adjustments.

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\* Offsetting gains and losses are inventory accounting adjustments that cancel each other out. Technicians review the IAR to identify offsetting gains and losses posted to CCSS inventory records for the same line item. The technicians annotate the IAR to show the offsetting gain and loss adjustments. Offsetting gain and loss adjustments are generally the result of a delay in posting transactions to both DSS and CCSS or the reversal of previously recorded transactions.

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## CECOM

In February 2007, shortly before our site visit, the accountable property officer and inventory personnel at CECOM revised written operating procedures for completing reviews of the inventory adjustments identified on the monthly IAR. The guidance was comprehensive and indicated that the accountable officer would review selected high-dollar inventory accounting adjustments, generally valued at more than \$1 million. The operating procedures required:

- inventory personnel to complete a checklist to document research performed,
- inventory personnel to complete reviews within 2 weeks,
- the accountable property officer to retain supporting documentation for 2 years,
- the accountable property officer to maintain a register to track the status of reviews in process, and
- the accountable property officer to review and approve the results of research performed.

However, the operating procedures did not contain detailed instructions on how to reverse accounting adjustments and correct inventory supply records, nor did it address the process for tracking and analyzing transactions to identify root causes of the adjustments.

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## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
Director, Acquisition Resources and Analysis  
Under Secretary of Defense (Comptroller)/Chief Financial Officer

### **Department of the Army**

Assistant Secretary of the Army (Financial Management and Comptroller)  
Auditor General, Department of the Army  
Program Executive Officer, Enterprise Information Systems

### **Other Defense Organizations**

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

### **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 Homeland Security and Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Oversight and Government Reform  
House Subcommittee on Government Management, Organization, and Procurement,  
Committee on Oversight and Government Reform  
House Subcommittee on National Security and Foreign Affairs,  
Committee on Oversight and Government Reform

# Under Secretary of Defense for Acquisition, Technology, and Logistics Comments



DEPUTY UNDER SECRETARY OF DEFENSE FOR  
LOGISTICS AND MATERIEL READINESS  
3500 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3500

MAR 12 2008

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL AND DIRECTOR, DEFENSE  
FINANCIAL AUDITING SERVICE, DoDIG

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS *YB 3/12/08*

SUBJECT: Response to DoDIG Draft Report on Controls Over Army Working Capital Fund  
Inventory (Project No. D-2007-D000FI0061.000) dated January 10, 2008

As requested, I am providing a response to the general content and recommendations contained in the subject report.

**Recommendation 1:** We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics revise the DoD Instruction 4000.25-2-M guidance for performing the annual and end-of-day reconciliations of the storage activity's inventory records to the national inventory manager's record.

**Response:** **Concur** with recommendation 1 with the exception noted in 1e which is addressed in the next paragraph. We will conduct a review of the DoD 4004.25-M to define necessary policy adjustments. We expect to complete this review by September 30, 2008.

**Recommendation 1e:** Require storage activities and inventory materiel managers to perform the annual inventory reconciliations during September, close to fiscal year's end.

**Response:** **Partially Concur.** If Quantitative Location Reconciliations (QLRs) for all Services' are scheduled during the month of September, it would not allow the required 45 day timeframe for error correction prior to fiscal year's end. Recommendation the language in the report be changed to state: "QLRs should be performed prior to Chief Financial Officer Inventories (September) that are currently scheduled to occur close to the fiscal year-end".

**RECOMMENDATION 2 & 3:** Assigned to Army G4 and Army Materiel Command respectively.

Please contact Ms Debra Bennett, 703-604-0098, ext 201, [debra.bennet@osd.mil](mailto:debra.bennet@osd.mil), if additional information is required.

*Jack Bell*  
Jack Bell




## Deputy Chief of Staff, Army G-4 Comments



DEPARTMENT OF THE ARMY  
OFFICE OF THE DEPUTY CHIEF OF STAFF, G-4  
500 ARMY PENTAGON  
WASHINGTON, DC 20310-0500

DALO-SUS-SI

29 Feb 08

MEMORANDUM THRU  DEPUTY CHIEF OF STAFF, G-4, 500 ARMY PENTAGON,  
WASHINGTON, D.C. 20310

FOR U.S. ARMY AUDIT AGENCY, ATTN: SAAG-PMO-I, 3101 PARK AVENUE,  
ALEXANDRIA, VA 22302

SUBJECT: Department of Defense Inspector General (DoDIG) Draft Report—Controls  
Over Reconciling Army Working Capital Fund Inventory (D2007-FI-0061)

1. The Army G-4 concurs with the DoDIG recommendations to update Army Regulations 740-26 and 735-5 to ensure they are in agreement with Department of Defense (DoD) 4000.25-2-M.
2. The U.S. Army regulations will be reviewed in accordance with DoD 4000.25-2-M and changes will be incorporated in the next published update.
3. Points of contact are Ms. Rhonda Cunningham-Still, (703) 695-6169, or e-mail: rhonda.cunningham-still@hqda.army.mil and Mr. David Babin, (703) 692-9599, or e-mail: david.babin@hqda.army.mil.

  
SARAH H. FINNICUM  
Director of Supply



# Program Executive Office, Enterprise Information Systems Comments



DEPARTMENT OF THE ARMY  
OFFICE OF THE PROGRAM EXECUTIVE OFFICER  
ENTERPRISE INFORMATION SYSTEMS  
(PEO EIS)  
9350 HALL ROAD, SUITE 148  
FORT BELVOIR, VIRGINIA 22060-5526

SFAE-PS-A

8 February 2008

MEMORANDUM FOR Assistant Inspector General for Defense Financial Auditing Service,  
ATTN: Mr. Carmelo G. Ventimiglia, 400 Army Navy Drive, Arlington, Virginia 22202-4704

SUBJECT: DODIG Draft Report dated 10 January 2008 – Controls Over Reconciling Army  
Working Capital Fund Inventory (D2007-D000FI-0061.000)

1. Enclosed is the Program Executive Office, Enterprise Information Systems (PEO EIS) reply to the subject draft report. Specific comments from PMO Logistics Modernization Plan (LMP) are enclosed and have been concurrently incorporated into Army Materiel Command's response, which is being submitted under separate cover.
2. If you have any questions, please contact Ms. Nicole Wohl DSN 656-3632, commercial 703-806-3632 or via email at Nicole.wohl@us.army.mil.

A handwritten signature in cursive script, reading "Terry Watson", is positioned above the printed name.

TERRY WATSON  
Director, Acquisition Management  
PEO Enterprise Information Systems

SFAE-PS-A

SUBJECT: Comments to DODIG Draft Report dated 10 January 2008 – Controls Over Reconciling Army Working Capital Fund Inventory (D2007-D000FI-0061.000)

LMP submits and respectfully requests that the statements reflected below be included in the final report.

1. LMP non-concurs with the DODIG observation on improper reversal of gain and loss adjustments. SAP does not allow cancellation of standard SAP inventory adjustments for movement types 711 and 712. Additionally, for auditability and security reasons, it is a best business practice not to allow cancellation of standard inventory adjustment of goods movements.

2. LMP concurs with the DODIG observations on unit of issue and unit of measure. In September 2006, CECOM opened a help desk ticket to resolve improper adjustments for line items with a unit of issue different than a unit of measure. LMP is currently working Change Request number 23537 which resolves this issue. The resolution is currently planned for promotion to production April 2008.

End of Response

Observations  
previously  
deleted from  
draft report

# U.S. Army Materiel Command Comments



REPLY TO  
ATTENTION OF:

DEPARTMENT OF THE ARMY  
HEADQUARTERS, U.S. ARMY MATERIEL COMMAND  
9301 CHAPEK ROAD  
FORT BELVOIR, VA 22060-5527

AMCIR

26 February 2008

MEMORANDUM FOR Inspector General, Department of Defense, 400 Army Navy Drive,  
Arlington, VA 22202-4704

SUBJECT: DODIG Draft Report, Controls Over Reconciling Army Working Capital Fund  
Inventory (Project Number D2007-D000FI-0051.000) (AMC No. D0704)

Headquarters, U.S. Army Materiel Command (HQ AMC) has reviewed the subject draft report  
and generally concurs with the stated facts and recommendations. Specific comments are  
enclosed. HQ AMC point of contact is Mr. Tilden Jio, 703-806-9021.

FOR THE COMMANDER:

Encl

*Susan C. McCoy*  
SUSAN C. McCOY  
Director, Internal Review and Audit  
Compliance Office

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**Command Comments**  
**DODIG Draft Report: Controls Over Reconciling Army Working Capital Fund Inventory**  
**(D2007-D000FI-0061.000) (AMC D0704)**

**Objective:** Evaluate controls over the process of reconciling the AWCf inventory asset balances reported in DSS to the Army's supply records.

**Conclusion:** The annual and end-of-day inventory reconciliations are essential controls to ensure that the property accountability records maintained by distribution centers agree with the inventory records used by the LCMCs for supply management data and financial reporting. However, the LCMCs did not perform a complete and adequate review of inventory accounting adjustment transactions made to reconcile Army supply systems inventory asset balances to those recorded in DSS. The lack of effective processes and controls over the inventory reconciliations can result in inaccurate inventory records that distort the reports that inventory managers use to make decisions to buy, repair, and excess materiel, and impact the reliability and accuracy of the financial reports used to measure the performance of the AWCf Supply Management, Army activity group.

**Additional facts:**

AMC does not agree with the following statements made in the report and are providing comments to add clarity to the facts as stated in the report:

- Page 3, second sentence of paragraph titled, Review of Internal Controls, starting with, "AMC did not have internal controls implemented..."

- Page 4, second sentence after bullets, starting with, "AMC did not effectively monitor the LCMC inventory reconciliation..."

AMC disagrees with the DODIG's conclusion that there is a material internal control weakness. HQ AMC does manage the annual AMC audits and provides oversight at a macro management level for the entire process. Although currently there is no formal written policy memorandum or Letter of Agreement to enforce AR 740-26, HQ AMC has continuously worked with the LCMCs verbally and by electronic mail (e-mail) correspondence to ensure performance and reporting of all annual reconciliations of inventory. The following are actions HQ AMC has taken to ensure the reliability and accuracy of the financial reports:

- Develops, provides and monitors the annual audit schedule.
- Directs and provides Letter of Instructions for performing the audits.
- Maintains electronic files for the Location Audit List (309) reports.
- Selectively challenged LCMCs to provide justification for those storage sites not meeting the 97% goal. In Nov 2007, challenges were expanded to all storage sites not meeting goal.

Enclosure

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- In Nov 2007, AMC tasked the LCMCs to provide a summary explanation of causative research done for those items that meet the dollar value threshold.

**Recommendation 3:** We recommend that the Commander, U.S. Army Materiel Command:

a. Implement procedures to improve oversight of the annual and end-of-day inventory records reconciliations by requiring the Life Cycle Management Commands to:

(1) Include with the 309 Report a summary analysis of the underlying causes identified for not achieving the DoD accuracy goal on the annual reconciliation of inventory asset records.

(2) Identify actions taken or recommended to address the system and operational issues causing the erroneous, missing, and duplicate supply transactions that result in inventory accounting gain and loss adjustments.

(3) Accumulate and report quarterly the total number and dollar value of inventory accounting gain and loss adjustments (D8B and D9B transactions) resulting from the end-of-day inventory records reconciliations.

b. Pending revisions to DoD 4000.25-2-M and Army Regulation 740-26, issue interim guidance to the Life Cycle Management Commands for performing the annual and end-of-day reconciliations of inventory records. Specifically:

(1) Establish standard criteria for selecting adjustments to research. If available resources constrain the review of adjustments, require the Life Cycle Management Commands to focus on inventory accounting gain and loss adjustments that most affect the accuracy of supply management and financial data.

(2) Identify a standard timeframe for completing research of inventory accounting adjustments.

(3) Require the Life Cycle Management Commands to include in their operating procedures detailed guidance for:

(a) researching adjustments and correcting the underlying supply transactions that caused the discrepancy in asset balances;

(b) documenting the causative research performed and corrective actions taken and the time period documentation must be retained;

(c) tracking and analyzing supply transaction errors to identify the root cause of the inventory adjustments; and

(d) documenting management approval and oversight.

**Command Comments:** Partially concur. The following are comments for each subpart of the recommendation:

- 3.a. Concur. The U.S. Army Materiel Command (AMC) has taken the following actions to implement the recommendations:

- 3.a.(1). Concur. Analysis is performed and reported on depots not meeting the 97% DoD accuracy goal. This has been ongoing since November 2007.

- 3.a.(2). Concur. Actions are on-going to address system and operational issues affecting inventory gain and loss adjustments. All trouble tickets, engineering change requests, operational systems changes and process improvement recommendations are reviewed and implemented when cost effective as soon as possible to correct problems affecting inventory gain and loss adjustments.

- 3.a.(3). Partially concur. The U.S. Army Materiel Command does not agree that LCMCs (except CECOM LCMC) be required to report quarterly the accumulated dollar values for D8B and D9B transactions. There is limited value for this requirement. Reporting this quarterly will not improve the result of the overall reconciliation because in most cases one day's gain is the next day's loss or vice versa. However, the Logistics Modernization Program (LMP) does have this reporting capability. Therefore, CECOM LCMC will maintain quarterly reports and provide to HQ AMC, as required. As LMP is fielded to the other LCMCs (AMCOM fielding is March 2009) the quarterly reporting will expand accordingly.

- 3.b. Concur. HQ AMC will take actions to implement the recommended actions:

- 3.b.(1). Concur. Standard criteria for selecting adjustments to research will be developed and included in guidance to the LCMCs by 30 September 2008.

- 3.b.(2). Concur. The guidance that will be developed for recommendation 3.b.(1) will include the timeframe requirement for completing the research of inventory accounting adjustments.

- 3.b.(3). Concur. LCMCs will be instructed to develop written operating procedures to include guidance as stated in the recommendations. Further, the LCMCs will be required to provide a copy of their written guidance for review by 30 September 2008.

## **Team Members**

The Department of Defense Office of the Deputy Inspector General for Auditing, Defense Financial Auditing Service prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

Patricia A. Marsh  
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# Inspector General Department of Defense

