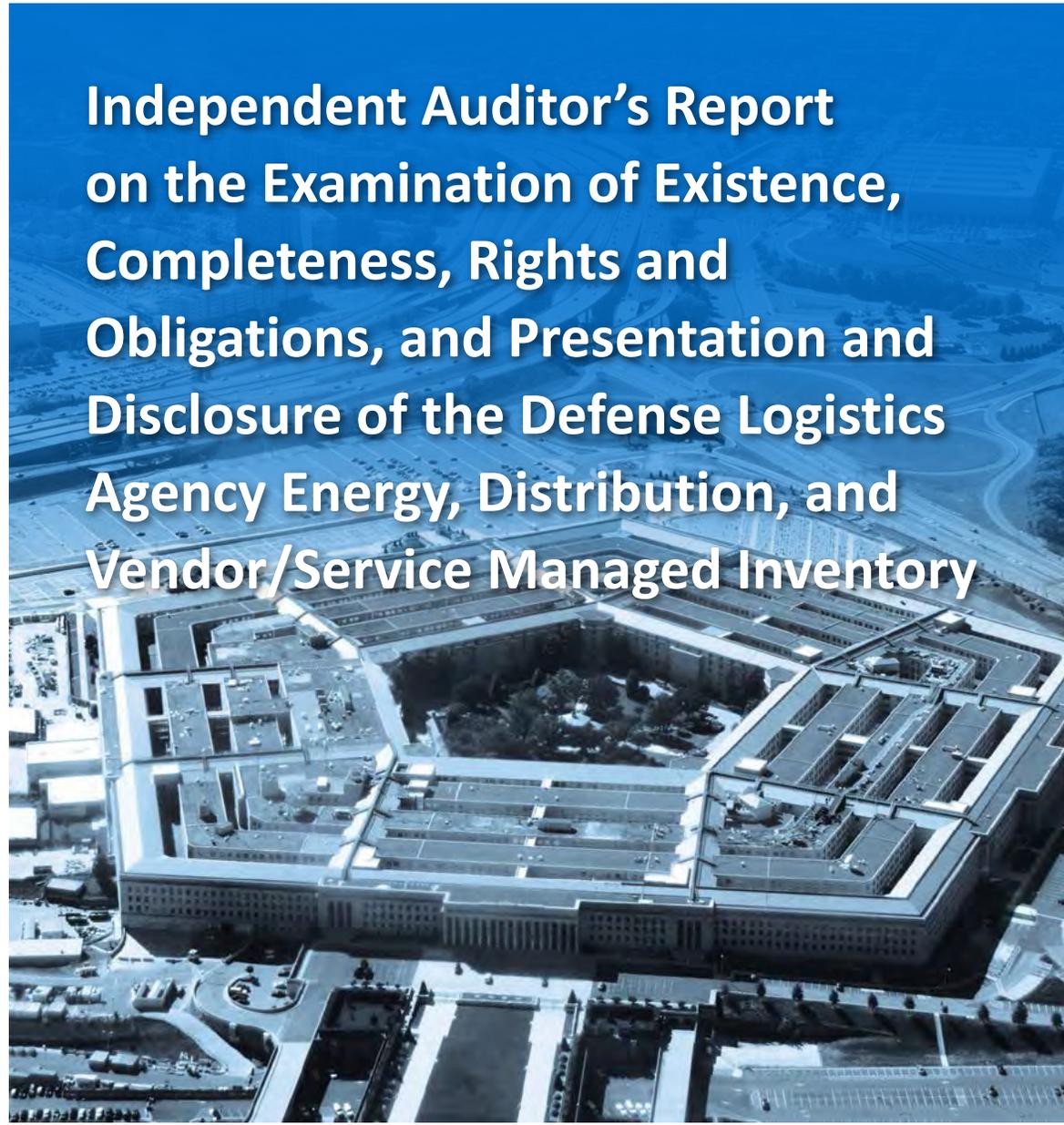




# INSPECTOR GENERAL

*U.S. Department of Defense*

DECEMBER 22, 2015



## **Independent Auditor's Report on the Examination of Existence, Completeness, Rights and Obligations, and Presentation and Disclosure of the Defense Logistics Agency Energy, Distribution, and Vendor/Service Managed Inventory**

INTEGRITY ★ EFFICIENCY ★ ACCOUNTABILITY ★ EXCELLENCE

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*Our vision is to be a model oversight organization in the Federal Government by leading change, speaking truth, and promoting excellence—a diverse organization, working together as one professional team, recognized as leaders in our field.*



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**INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
4800 MARK CENTER DRIVE  
ALEXANDRIA, VIRGINIA 22350-1500**

December 22, 2015

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

SUBJECT: Independent Auditor's Report on the Examination of Existence, Completeness, Rights and Obligations, and Presentation and Disclosure of the Defense Logistics Agency Energy, Distribution, and Vendor/Service Managed Inventory (Report No. DODIG-2016-037)

We are providing this report for your information and use. No written response to this report was required; therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945.

A handwritten signature in cursive script that reads "Lorin T. Venable".

Lorin T. Venable, CPA  
Assistant Inspector General  
Financial Management and Reporting





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DEPARTMENT OF DEFENSE  
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## Opinion

We examined the Defense Logistics Agency (DLA) management's assertion of audit readiness<sup>1</sup> dated July 1, 2015, for the existence, completeness, rights and obligations, and presentation and disclosure of the DLA Energy, Distribution, and Vendor Managed Inventory balances reported as of March 31, 2015.

DLA management is responsible for its assertion of audit readiness. Our responsibility is to express an opinion on the assertion based on our examination.

We conducted this examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and with generally accepted government auditing standards. Those standards require examining, on a test basis, evidence supporting DLA's assertion of audit readiness of its Energy, Distribution, and Vendor Managed Inventory. We tested the existence and completeness of the inventory, as well as the associated rights and obligations, and presentation and disclosure. We also performed other procedures we considered necessary. We believe our examination provides a reasonable basis for our opinion on management's assertion.

DLA asserted audit readiness of its inventory in September 2014. Because DLA inventory balances frequently fluctuate, DLA provided a universe of inventory assets as of March 31, 2015, to coincide with the start of our examination, and provided a revised assertion letter dated July 1, 2015. The March 31, 2015, inventory quantity balance was 4,948,513,649.<sup>2</sup> The Appendix to this

<sup>1</sup> Audit readiness per the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer "Financial Improvement and Audit Readiness (FIAR) Guidance," dated April 2015. Specifically, Appendix B, Wave 3 – Mission Critical Asset Existence and Completeness Audit Key Supporting Documents.

<sup>2</sup> DLA's assertion identified the total inventory value as \$17.6 billion but DLA did not assert to inventory valuation. DLA has various types of inventory including subsistence (food), clothing, construction materials, batteries, medical materials, and repair parts as well as petroleum products. Inventory is held in many different units including eaches, hundreds, and gallons.

report provides a breakout of DLA's asserted inventory balance by category and also identifies the categories included in our examination. In its assertion, DLA stated that it was asserting rights and obligations and has maintained supporting documentation in accordance with the National Archives and Records Management General Records Schedule 3 guidelines, which calls for record retention of 6 years and 3 months.

DLA policy<sup>3</sup> requires energy locations to record fuel quantities in pipelines used to transfer fuel between tanks and throughout the location identified in the inventory records. In addition, the policy requires engineering personnel to certify the pipeline fuel quantities. DLA did not provide complete population data for the quantity of fuel in pipelines at all energy locations visited. We could not quantify the extent of this issue DLA-wide, but 23 of the 38 energy sites we visited did not report pipeline fuel quantities as inventory or did not have reported pipeline fuel quantities certified. DLA was unable to determine the magnitude of this issue and initiated corrective actions in response to our inquiries. DLA informed us that it performed an evaluation of the evidential matter for pipeline quantities and mandated that an estimate be submitted at the end of FY 2015 for quantities not reported.<sup>4</sup> DLA also informed us that it will refine the accrual calculation to support the end-of-month inventory quantity reporting and are developing a plan to ensure all pipeline fuel quantities are identified, certified, and included on the end-of-month reporting.

Vendor managed inventory sites use several different accountable property systems of record and DLA must reconcile the inventory balances to its Enterprise Business System on a monthly basis. A material variance existed between the accountable property systems of record and the DLA Enterprise Business System as of March 31, 2015. DLA informed us that, until it can correct the reconciliation problems with the vendor managed inventory sites, DLA plans to conduct wall-to-wall inventories to ensure the accuracy of the inventory records. In addition, DLA did not provide detailed population data for a portion of its asserted vendor managed inventory. DLA stated that this inventory is a type of Special Stock with Vendor and represents stock provided to a vendor for kitting,<sup>5</sup> assembly, or manufacturing purposes. This inventory represented approximately 30 percent of the vendor managed inventory DLA asserted to as of March 30, 2015. Because DLA did not provide the detailed population data, we were unable to test the Special Stock with Vendor inventory, which limited the scope of our examination.

We used a combination of statistical and non-statistical methods to test the distribution inventory items and used non-statistical methods to test the energy and vendor managed inventory. We tested the existence, completeness, rights, and presentation assertions related to each inventory segment. In our opinion, except for problems identified with the energy

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<sup>3</sup> DLA Energy - P -1, "Recording and Processing Inventory Transactions," December 23, 2013.

<sup>4</sup> We were unable to validate these corrective actions because they occurred after our examination site visits ended in September 2015.

<sup>5</sup> Kitting is the activity of putting two or more materials or items together to be sold as one unit.

and vendor managed inventory outlined in the above paragraphs, the DLA assertion of audit readiness related to inventory as of March 31, 2015, is fairly stated in accordance with DoD Financial Improvement and Audit Readiness Guidance Wave 3-Mission Critical Asset Existence and Completeness criteria and to the accountable property system of record.

## Internal Controls

Office of Management and Budget Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004, requires management to develop and maintain effective internal controls to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Internal controls are organizational policies and procedures to help program and financial managers achieve results and safeguard the integrity of their programs. During our examination, we identified internal control concerns, but with the exception of controls over the completeness of energy and vendor managed inventory, they did not prevent us from reaching an opinion on DLA's assertion related to inventory.

We identified the following internal control concerns.

- Of 38 energy locations, 17 were not performing or documenting the performance of required quarterly manual automatic tank gauge verifications in accordance with DLA policy.<sup>6</sup>
- Of the 186 tanks reviewed, we identified 56 where the automatic tank gauge measurement varied from the manual physical inventory measurement by an amount which exceeded the threshold acceptable by DLA policy.<sup>7</sup>
- Our testing at the distribution depots identified items missing labels, comingled stock, condition code errors, and unit of issue errors. At least one issue was found at each of the eight depots visited. DLA personnel generally took action to correct these issues when we brought them to their attention.
- One of the two vendor managed inventory locations we visited failed our existence testing and both sites failed our completeness testing.

Improving these internal control processes will help DLA repeat and sustain the inventory audit readiness process during future financial statement examinations.

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<sup>6</sup> DLA Energy-P-7, "Accountability and Custodial Responsibilities for Defense Working Capital Fund (DWCF) Inventory and Government Property," February 5, 2014, requires the inventories be performed on a quarterly basis and documented.

<sup>7</sup> DLA Energy-P-7 requires the measurements to be within 3/16 of an inch.

We provided a discussion draft of this report to DLA management, who provided comments that we have incorporated as appropriate. This report will be made publicly available pursuant to section 8M, paragraph (b)(1)(A) of the Inspector General Act of 1978, as amended. However, this report is intended solely for the information and use of the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, and the Director, DLA and is not intended to be used and should not be used by anyone else.

A handwritten signature in black ink that reads "Lorin T. Venable". The signature is written in a cursive style with a clear, legible font.

Lorin T. Venable, CPA  
Assistant Inspector General  
Financial Management and Reporting

## Appendix. DLA's Asserted Inventory Balance As Of March 31, 2015

Table. Breakout of DLA's Asserted Inventory Balance By Category

Inventory Category	Quantity	Percent of Total
Distribution	2,383,243,953	48.16
Energy*	2,331,201,755	47.11
Vendor Managed	225,664,684	4.56
Other**	8,403,257	0.17
<b>Totals</b>	<b>4,948,513,649</b>	

\* We did not review 277,048,321 (12 percent) of this quantity that was included in major pipelines or stored on afloat ships.

\*\* The "Other" inventory category above was excluded from the examination and consists of immaterial inventory amounts from the Service Managed Inventory (DLA-owned items that are in the Military Services custody and maintained in information systems outside DLA), Ozone Plants (DLA facilities responsible for managing DoD's ozone depleting substances such as refrigerants and solvents), and Document Services (DLA organization that provides document automation and records management services for DoD).



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## **U.S. DEPARTMENT OF DEFENSE**

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