United States General Accounting Office

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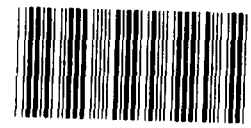
Report to Congressional Requesters

December 1987

INVENTORY MANAGEMENT

Defense Logistics Agency Inventory Accuracy Problems



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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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December 24, 1987

The Honorable Pete Wilson
United States Senate

The Honorable John Glenn
Chairman, Committee
on Governmental Affairs
United States Senate

As requested in Senator Wilson's letter of April 15, 1987, we reviewed the Defense Logistics Agency's inventory management. This is one in a series of reports related to the effectiveness of defense logistics.

As arranged with your Offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to interested committees and other members of Congress; the Secretary of Defense; the Director, Defense Logistics Agency; and the Director, Office of Management and Budget. Copies will also be made available to other parties upon request.

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

The Defense Logistics Agency (DLA) buys, stores, and issues billions of dollars of supplies annually to support the military services. Effective management of these items is necessary to ensure that they are available to support the services' needs but are not overstocked, which could result in a waste of government funds. Accurate inventory records and adequate physical security over these inventories are integral elements in providing this assurance.

GAO evaluated the accuracy and completeness of DLA's inventory records, its research into differences between physical inventory counts and its records, and the adequacy of physical security to protect DLA's inventories.

Background

Each year DLA's six supply centers, which are responsible for supply management over DLA commodities, buy billions of dollars of supplies, which are located at its six depots. These depots store DLA's commodities until they are issued to military units worldwide. In addition to the inventories at its own depots, DLA stores about 23 percent of its material at 56 facilities operated by the military services. As of June 30, 1987, DLA inventories were valued at about $9.07 billion, excluding fuels.

In addition to managing some items unique to weapon systems, DLA is the Department of Defense (DOD) central manager for commonly used, consumable supply items, many of which have low unit value. Overall DLA stocks a total of 1.9 million items, 52 percent of which have unit costs under $10.

To gain a perspective on DLA's supply system, GAO reviewed policies, procedures, and reports at DLA Headquarters, at two supply centers—the Defense Industrial Supply Center and Defense Personnel Support Center—and DLA's Mechanicsburg depot.

Results in Brief

GAO found that data reported by DLA, as required in DOD's Inventory Control Effectiveness (ICE) report, did not reflect actual inventory accuracy conditions at DLA depots. Criteria for reporting record accuracy, which is based only on variances over $800, may not be appropriate for DLA which, unlike the services, manages a large volume of low value, consumable items. GAO's physical inventories of a sample of items at DLA's Mechanicsburg depot showed high overall inventory accuracy for quantity and dollar value of items on hand. However, analysis of our sample,

which was stratified by commodity, disclosed some problem areas needing management attention. GAO also found that although efforts have been made to determine the causes of inventory inaccuracies, causative research could be more effective if DLA researched a sample of adjustments of $800 or less to determine if there are trends or systemic concerns that need attention. Finally, physical security over inventories continues to need improvement.

Principal Findings

Inventory Accuracy Data Could Be More Useful

Unlike the military services, DLA's reported ICE data is influenced not only by how well DLA manages the inventories under its control at its depots but also by how well the services manage the large quantities of DLA material under their control at their storage activities. For example, in fiscal years 1985 and 1986, overall DLA showed a $43.7 million inventory net gain. However, GAO's analysis of data in DLA's six depot quarterly reports showed an overall net loss of $37.4 million at the depots. The data in DLA's ICE report needs to be more informative if it is to be used effectively by DOD to evaluate DLA inventory management.

Another measure of inventory accuracy is records accuracy, that is, how often the inventory record and the on-hand material balances agree. The record accuracy rate computation in the ICE report does not consider records with gains or losses $800 and under. Therefore, this measure does not present a complete picture of DLA's record accuracy. For example, for fiscal year 1986, DLA's reported records accuracy was 84.3 percent; however, based on available data, GAO determined that 88 percent of DLA's record adjustments were $800 and under and were therefore not included in this accuracy figure.

Sample Results Indicate Some Accuracy Problems

Overall, GAO's statistical sample of 454 items valued at about $7 million at DLA's Mechanicsburg depot showed that the inventory records agreed exactly with the physical count 63 percent of the time, yet the quantity and dollar accuracy rates were relatively high considering the kinds of items that DLA manages. Still, an analysis of GAO's sample data, which was stratified by commodity, disclosed some problem areas that need management attention.

For example, the record accuracy rates for items receiving special storage in vaults or caged areas were about the same as the 63 percent records accuracy rate for all items in our DLA sample. While records were inaccurate for vault-stored items, the monetary and quantity accuracies of 98.8 percent and 98.6 percent, respectively, were near the 100-percent accuracy one would expect for this type of controlled storage. The caged items, however, had much lower accuracy levels—90.9 percent for dollar value and only 69.5 percent for quantity accuracy.

Causative Research Could Be More Effective

DOD requires causative research into differences between physical inventory counts and its records on a complete or sample basis on inventory variances for controlled items and for noncontrolled items over $800 per line item. GAO found that of the 370,588 adjustments made by DLA during fiscal years 1985 and 1986, 321,841 (87 percent) were $800 or less. Although variances in controlled items of $800 or less are subject to research, GAO sample results show that controlled items represent less than one-half of one percent of DLA items. Even though the value of individual item variances are relatively small when there are so many and the reasons are not identified, potential corrective measures cannot be evaluated and incidents of theft or pilferage could go undetected.

Although DLA's supply centers had identified some basic inventory accuracy problems and prepared numerous research reports, GAO found that the Inventory Control Branch at the Mechanicsburg depot had not monitored the depot's actions to determine that the results were used to identify, analyze, and correct causes of repetitive errors. Additionally, GAO found that 23 of 48 research reports prepared by the supply centers during fiscal years 1985 and 1986 to identify causes for adjustments were not available at the depot; therefore, corrective actions could not be taken.

Physical Security Still Needs Improvement

GAO found that (1) prescription and nonprescription drugs and medicines were stored in a warehouse where access was not restricted, (2) other pilferable items were improperly stored in open boxes, and (3) the depot stored items on loading docks. In addition, because of limited installation parking, privately owned vehicles were allowed to park next to the warehouses.

Recommendations

To provide DOD decisionmakers with more accurate, complete, and appropriate data, GAO recommends that the Secretary of Defense change

its policy regarding inventory effectiveness reporting to require DLA's inventory control effectiveness reports to separately identify inventory performance data for its own depots from that of military service sites at which DLA material is stored.

To ensure that physical inventories are representative and that causative research is an effective tool for identifying and correcting recurring causes of inventory variances, GAO recommends that the Director, Defense Logistics Agency, require that

- statistical samples of items be taken by commodity type and that the record, quantity, and dollar value accuracy indicators be collectively analyzed to identify areas for further analysis;
- its planned reassessment of the causative research criteria include a determination whether a sample of adjustments under $800 should be researched annually; and
- centers and depots establish controls for the proper distribution of quarterly causative research reports and follow up on corrective actions for identifying inventory variances.

Additionally, GAO recommends that the Director require the Mechanicsburg depot to take immediate action to correct known security problems and emphasize the need to properly store pilferable-type items.

Also, the Director should consider including inventory accuracy again as a material weakness in the next internal controls annual assessment.

Agency Comments and GAO's Evaluation

DOD concurred with GAO's recommendations regarding statistical sampling by commodity type for physical inventories, distribution of and follow-up on corrective actions identified in quarterly causative research reports, and the need for improved physical security at the Mechanicsburg depot and noted planned or ongoing corrective actions in these areas. DOD did not agree with the recommendations as written in GAO's draft report regarding DLA inventory accuracy data reported in the ICE report, sample causative research of inventory adjustments, and the need for reporting on inventory accuracy in DLA's next internal controls annual assessment. GAO considered DOD's comment in framing its final recommendations.

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Abbreviations

C&T	Clothing and Textile
DCSC	Defense Construction Supply Center
DESC	Defense Electronics Supply Center
DFSC	Defense Fuel Supply Center
DGSC	Defense General Supply Center
DISC	Defense Industrial Supply Center
DLA	Defense Logistics Agency
DOD	Department of Defense
DPSC	Defense Personnel Support Center
ICE	Inventory Control Effectiveness

Introduction

Inventory management is one of the Defense Logistics Agency's (DLA) largest and most complex missions. DLA buys, stores, and issues billions of dollars of supplies annually to support the military services. Effective management of these items is necessary to ensure that they are available to support the services' needs but are not overstocked, which could result in a waste of government funds.

DLA Supply System

DLA stocks 1.9 million supply items used by the military services worldwide. Although many of these items support weapon systems, a large number are commonly used, off-the-shelf, consumable items including food, clothing, medicines, fuels, spare parts, and general supplies. The items are grouped by commodity type, such as medical or electronics. About 52 percent, or 980,000 supply items, are valued at $10 or less per item.

At the end of fiscal year 1986, DLA's wholesale inventories were valued at about $8.1 billion, excluding fuels. For fiscal year 1986, it had procured $6.9 billion of supply items and had gross sales to the military services and other DOD components totaling about $6.3 billion. As of June 30, 1987, DLA's inventories were valued at about $9.07 billion.

The 1.9 million items are managed by the following DLA supply centers, which are responsible for supply management of an assigned commodity or commodities:

- Defense Construction Supply Center (DCSC), Columbus, Ohio;
- Defense Electronics Supply Center (DESC), Dayton, Ohio;
- Defense Fuels Supply Center (DFSC), Alexandria, Virginia;
- Defense General Supply Center (DGSC), Richmond, Virginia;
- Defense Industrial Supply Center (DISC), Philadelphia, Pennsylvania; and
- Defense Personnel Support Center (DPSC), Philadelphia, Pennsylvania.

DLA also operates six inventory supply depots, which are responsible for storing a wide range of DLA commodities for the support of the military services worldwide and are located at Columbus, Ohio; Richmond, Virginia; Mechanicsburg, Pennsylvania; Memphis, Tennessee; Tracy, California; and Ogden, Utah.

In addition, according to DLA, $2 billion, or about 23 percent, of its inventory is stored at 56 facilities operated by the military services.

Inventory Control and Accountability

Inventory control programs are designed to assist management in maintaining accuracy and consistency of physical assets and their related records at the storage locations and the accountable inventory records at supply centers. Because of the continuous daily flow of equipment and supplies into and out of the DLA supply system through receipt and issue transactions, these accountable records are continuously updated. Updating records provides numerous opportunities to make errors, creating imbalances between actual assets on hand and inventory records. Consequently, the Department of Defense (DOD) has established inventory control policies and procedures for its components, including DLA, to follow in

- taking physical inventories,
- conducting audits to verify stock location,
- researching potential and actual inventory adjustments,
- establishing quality control programs, and
- reporting inventory control effectiveness.

Items within DLA's supply system are categorized as either controlled or noncontrolled. Controlled items must be identified, accounted for, secured, segregated, and handled in a special manner. Controlled items are further identified as

- sensitive: items that by law require a high degree of protection, such as narcotics and precious metals, or
- pilferable: items that require special protection because of their high resale value or desirability for personal use or possession, such as watches or tools.

Sensitive items must be stored in a safe or vault, and pilferable items must be stored in a cage or locked area. Controlled items also include classified material, which requires the highest degree of protection; however, according to DLA, it does not store classified items. Noncontrolled items are stored in general-purpose storage areas with only general protective measures.

DLA depots are required to schedule annual physical inventories of all controlled items and selected noncontrolled items. Noncontrolled items are selected for inventory by a computer model, which considers various weighted factors such as the number of months until next procurement, annual dollar value or quantity of demand, the weapon system supported, annual demand frequency, and production lead time. Depots are required to take unscheduled physical inventories of designated items

when requested by accountable inventory management activities, such as supply centers, or whenever needed to confirm and correct suspected discrepancies. During the last 2 fiscal years, DLA inventoried 33 and 21 percent of the total dollar value of its inventories.

After taking physical inventories, the depots perform post-count validation and pre-adjustment research, depending on the value of the potential inventory variances. Post-count validation compares the original physical count with a recount to determine the validity of the original count. Pre-adjustment research determines the correct balance through reconciliation of recent transactions, called in-float documentation. Subsequently, the depots are to promptly report the physical counts to the appropriate supply center. When the physical counts do not agree with the supply center's inventory record balance, the accountable inventory records are adjusted.

After making adjustments to accountable inventory records, supply centers are required to perform causative research on a complete or sample basis on inventory discrepancies for controlled items and those for non-controlled items over $800. Causative research should determine the reasons for the difference between actual and recorded inventories. It consists of a complete review of all transactions, catalog data changes, shipment discrepancies, and unposted or rejected documentation occurring since the last physical inventory. The purpose of this research is to provide managers with indications of failures in control systems and of potential areas for improvement; reduce similar inventory discrepancies in the future; ensure that proper adjustments were made to the inventory records; and evaluate trends or systemic problems so that corrective actions can be taken. Research ends when the cause of the discrepancy has been discovered or when, after reviews of the transactions, no conclusive findings are possible.

The results of DLA's inventory control performance are included in DOD quarterly Inventory Control Effectiveness (ICE) Reports. These reports are intended to inform management of performance related to material orders, receipt processing, inventory location accuracy, line item (record) accuracy, and the monetary value of the physical inventory program to include the value and rates of inventory adjustments. DOD views inventory adjustments as a measure of the accuracy of inventory records. A key measure of physical inventory performance that gets reported to DOD is the gross inventory (monetary) adjustment rate. This rate is intended to be a measure of inventory accuracy and is expressed

as a percentage of gross inventory adjustments (the dollar sum of inventory gains and losses) to both total average inventory value and the value of material inventoried.

Physical inventory adjustments are accounting transactions intended to make book balances agree with the quantity of items in storage. They are expressed as either inventory gains or losses and may result from such events as physical inventory counts. Supply centers are allowed to reverse these adjustments if causative research shows that the adjustments were due to prior erroneous transactions, such as duplicate recording of a receipt or issue transaction or erroneous inventory counts.

DOD computes a monetary accuracy rate based on inventory adjustments; however, DOD recognizes that gross adjustments—gains and losses—combined with reversals of prior adjustments give a more complete picture of DOD's inventory record accuracy. Although reversals are reported, they are not used in the adjustment rate computation. Table 1.1 shows DLA's gross adjustment rates and the impact of reversals on those rates for fiscal years 1985 and 1986.

Table 1.1: Gross Inventory Adjustment Rates With and Without Reversals

Dollars in thousands

	Fiscal year	
	1985	**1986**
Average value of inventory	$7,673,035	$8,124,700
Value of items inventoried	2,518,166	1,715,943
Gross adjustments (gains and losses)	407,438	338,773
Value of inventory adjustment reversals	505,659	491,649
Total adjustments	**$913,097**	**$830,422**
Gross adjustment rates without reversals		
Average value rate	5.3%	4.2%
Inventoried value rate	16.2%	19.7%
Gross adjustment rates with reversals		
Average value rate	11.9%	10.2%
Inventoried value rate	36.3%	48.4%

In accordance with DOD's ICE reporting requirements, DLA also reports on its line-item accuracy rate. This rate, which in 1986 was 84.3 percent, is based on the number of records not requiring adjustment compared to the number of records inventoried. Although all adjustments are included in the gross monetary adjustment rate, only those records with

major adjustments ($800 or more) are reported and included in computing the record accuracy rate.

Physical Security

The Joint Chiefs of Staff have defined physical security as those measures designed to safeguard personnel; prevent unauthorized access to equipment, facilities, material, and documents; and protect against espionage, sabotage, damage, and theft. Sound physical security procedures can reduce loss due to theft and misappropriation of supply items. Another important aspect of physical security and inventory control is accurate and prompt identification and reporting of inventory discrepancies. It is important to reduce paperwork errors through good inventory accountability in order to have accurate record balances, thereby avoiding an environment which may become conducive to theft.

Prior Audits

Since 1983, reviews by us and the DOD Inspector General have highlighted problems in DLA inventory management.

Hearings conducted in April 1983 on inventory management in the military supply system disclosed that inventory accuracy problems existed in the Army, Air Force, and DLA. Subsequently, in November 1983, we issued a report on the magnitude, causes, and impact of physical inventory adjustments in the Army, Air Force, and DLA.[1] We reported that

- the value of physical inventory adjustments reported by these agencies significantly understated the actual extent of their inventory record inaccuracies,
- continuing record inaccuracies frequently have an adverse impact on supply economies and readiness, and
- Army, Air Force, and DLA procedures and practices were generally not effective in identifying and correcting the causes of recurring major inventory record errors.

We attributed these conditions to inadequate management emphasis and priority, noncompliance with DOD's policy as well as inadequacies in policy and implementing procedures and practices, a shortage of qualified personnel, and a lack of individual accountability for actions affecting

[1] Navy's Progress in Improving Physical Inventory Controls and the Magnitude, Causes and Impact of Inventory Record Inaccuracies in the Army, Air Force, and Defense Logistics Agency (GAO/NSIAD-84-9, Nov. 4, 1983).

inventory record accuracy. DLA and DOD generally concurred with our findings and proposed certain actions to correct these problems.

During the period August 1983 through September 1984, the DOD Inspector General and the service audit groups performed a Defense-wide audit to evaluate DOD's control of its wholesale inventories and its implementation of our recommendations. In its summary report on this audit, dated August 16, 1985, the DOD Inspector General reported that overall, DOD and its components had responded appropriately to earlier congressional criticism.[2] However, the Inspector General also pointed out that some prescribed procedures needed to be refined or revised and the execution of many procedures was still seriously deficient. Regarding DLA, the Inspector General found that most of the conditions we previously reported still existed.

In 1983, DLA developed a 10-year plan to achieve optimal inventory record accuracy by 1993. This plan includes improvements in the following areas:

- quality control,
- command attention,
- individual accountability,
- training, and
- feedback on causative research.

In May 1986, we reported to Senator Wilson, then Chairman of the Senate Armed Services Committee Task Force on DOD Inventory Management, on the results of our review of inventory management practices within the Army, Air Force, Navy, Marine Corps, and DLA supply systems.[3] We identified potentially significant supply-management problems at all levels in areas of receipt confirmation, records accuracy, inventory taking, reconciliation and research of inventory discrepancies, retail activity controls over inventory, and physical security. As in past reports, we noted that many of these problems were systemic in nature and had existed for years.

We reported that DOD components had taken some corrective actions in response to past reports; however, we still found problem areas. The

[2]Defense-wide Audit of Physical Inventory Adjustments (Office of the Inspector General, Department of Defense, Aug. 16, 1985).

[3]Inventory Management: Problems in Accountability and Security of DOD Supply Inventories (GAO/NSIAD-86-106BR, May 23, 1986).

services and DLA continued to experience inaccuracies in inventory records and physical inventory adjustments. In many cases, causative research could not determine the underlying reasons for inventory discrepancies. In addition, the lack of adequate physical security over some inventories could result in theft, waste, and loss.

Objectives, Scope, and Methodology

The objectives of our review were to determine whether (1) physical inventory procedures ensure that accountable records accurately reflect inventories, (2) efforts to identify and correct the basic causes of inventory variances are complete and effective, and (3) physical security over the inventory is adequate. We reviewed management practices and traced supply transactions from several supply centers and one depot. We conducted audit work at or obtained information from

- DLA Headquarters, Alexandria, Virginia,
- Defense Personnel Support Center,
- Defense Industrial Supply Center,
- Defense Construction Supply Center,
- Defense Electronics Supply Center,
- Defense General Supply Center, and
- Defense Depot Mechanicsburg, Pennsylvania.

At DLA headquarters, two supply centers—Defense Personnel Support Center and Defense Industrial Supply Center—and the Mechanicsburg depot, we obtained, reviewed, and evaluated applicable inventory policies and procedures and discussed them with appropriate officials.

To assess record accuracy, we inventoried a statistical random sample of 454 items valued at $7 million, managed by selected supply centers and stored at the Mechanicsburg depot. In conducting our physical inventories, we adhered to procedures governing counts and reconciliations, including additional counts if required. Also, Mechanicsburg's Inventory Control Branch personnel responsible for routinely conducting the depot's physical inventories accompanied us and certified the inventory counts.

Accuracy was defined as the degree of agreement between what we found in our physical inventory and what was shown on DLA's records. We stratified our sample by commodity and type of storage, for example, medical items in general storage or in the vault. We computed and evaluated several indices of inventory accuracy. We evaluated accuracy based on the number of items (national stock numbers) that showed

exact matches between the physical inventory counts and the supply center's inventory records. Another accuracy rate was computed based on the proportion of dollar values on the books that represented discrepancies from the physical inventory. Further, inventory accuracy was evaluated based on the proportion of physical units on the books that represented discrepancies from the physical inventory.

Our sample was taken from the Mechanicsburg depot's locator file, and the data was aggregated so that each case represented one stock number. Because our sample was statistically selected from the depot's records, we were able to project the results of our physical inventory to the total $920.6 million value of items stored at the depot. By inventorying the items and reconciling differences with depot and center records, we were able to evaluate the inventory system and the system's accountability for and physical security of controlled and noncontrolled items.

Our review was conducted between April 1986 and May 1987 in accordance with generally accepted government auditing standards.

Assessment of Internal Controls

Internal controls are an essential element of effective inventory management and when properly implemented they help ensure that

- obligations and costs comply with applicable law;
- all assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
- revenue and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained.

The Federal Manager's Financial Integrity Act of 1982 requires agency heads to (1) conduct an annual assessment of their internal controls, using guidelines established by the Office of Management and Budget, and (2) provide annual reports to the President and Congress that state whether agency systems of internal control comply with the objectives of internal controls set forth in the act and with the standards prescribed by the Comptroller General inthe Standards for Internal Controls in the Federal Government.[4] Where systems do not comply, agency reports must identify the weaknesses involved and describe the plans

[4]Standards for Internal Controls in the Federal Government (U.S. General Accounting Office, 1983).

for corrective action. DLA provides its assessments to DOD for inclusion in the Secretary of Defense's report to the President and Congress.

We reviewed DLA's fiscal years 1984 to 1986 annual assessments to determine if they identified significant weaknesses pertaining to inventory management. As a result of its fiscal year 1984 assessment, DLA reported that procedural weaknesses at supply centers and depots resulted in incorrect physical inventories. In its fiscal years 1985 and 1986 assessments, DLA reported on the status of corrective actions. In further describing the material weakness, DLA noted that the reported value of physical inventory adjustments significantly understated the actual extent of the inventory record inaccuracies and an acceptable level of inventory record accuracy was not being achieved because the basic causes of recurring errors had generally not been identified and corrected.

The fiscal years 1985 and 1986 assessment reports stated that since August 1984 various corrective actions had been taken, which included

- ensuring that employees are properly supervised and trained,
- establishing an agency-wide quality program,
- correcting erroneous computer programs, and
- establishing a feedback system with service depots storing DLA materials.

The fiscal year 1986 report noted that implementation of the feedback system completed action on this material weakness.

We are concerned that it may be premature for DLA to assess its actions as complete. As discussed in chapter 2, DLA inventory accuracy is relatively low in some areas. Further, DLA needs to ensure that its actions have actually corrected the weakness before reporting its corrective actions as complete.

Inventory Management: Further Improvements Needed

Sufficient but not excessive inventories are needed for DLA to accomplish its support mission in a cost-effective manner. Managing DLA's over $9 billion inventory to meet this objective is a difficult task. Accurate inventory records are needed to determine what, how much, and when to buy. In addition, adequate physical security is a prerequisite to prevent waste, fraud, and abuse.

During our review, we found that

- data reported by DLA, as required in DOD's ICE reports, did not reflect actual inventory accuracy conditions at DLA depots;
- our statistical sample comparing asset balances on hand to inventory records disclosed specific problem areas;
- causative research could be more effective; and
- physical security still needs improvement.

Inventory Accuracy Data Could Be More Useful

While DLA follows DOD inventory control effectiveness reporting criteria, its reported inventory performance could better reflect DLA's depot inventory accuracy. This information would be useful for DOD oversight.

ICE Report Data on the Value of Inventory Gains and Losses Do Not Reflect Actual Conditions at DLA Depots

DLA inventory control effectiveness reports show the value of DLA's inventories and inventory adjustments at its depots; however, these values also include inventories and adjustments for DLA material located at 56 facilities operated by the military services. These reports do not provide DOD management with sufficiently specific performance data to evaluate DLA's management of material in its depots, because the reports are distorted by how well the services manage their inventories of DLA items.

DLA's ICE reports for fiscal years 1985 and 1986 showed a $43.7 million net inventory gain for the period. However, DLA's six depots' quarterly summary data on its physical inventory program for the same period disclosed an overall net loss of $37.4 million. This summary data is prepared for internal DLA use and is not submitted to DOD.

Our analysis of the summary data showed that for the 2-year period, three depots had a combined $40 million net loss while three depots had a combined $2.6 million net gain. All DLA depots storing medical items had net losses, and except for Memphis all depots experienced net losses

for clothing and textile (C&T) items. Table 2.1 shows the total net inventory gains and losses for fiscal years 1985 and 1986 by commodity for the six DLA storage depots except in those cases where a commodity is not stored at a particular depot.

Table 2.1: Net Inventory Gains and (Losses) **By Commodity for Fiscal Years 1985 and 1986**

Dollars in millions

	Defense depots						
Commodity	**Mechanicsburg**	**Tracy**	**Ogden**	**Columbus**	**Memphis**	**Richmond**	**Total**
Construction	$0.23	$0.77	$0.86	$(0.61)	$(1.38)	$(0.48)	$(0.61)
Electronics	0.18	0.05	0.33	•	(1.22)	3.84	3.18
General	0.68	1.37	(0.09)	0.11	(2.80)	(6.30)	(7.03)
Industrial	0.39	0.99	0.71	1.20	(3.77)	(2.40)	(2.87)
Medical	(1.26)	(0.98)	(0.24)	•	(1.52)	•	(4.00)
C&T	(2.88)	(0.52)	(0.75)	(0.56)	0.43	(21.76)	(26.02)
Total	**$(2.66)**	**$1.68**	**$0.82**	**$0.14**	**$(10.26)**	**$(27.10)**	**$(37.38)**

We believe that data in the ICE report needs to be more informative if it is to be used effectively by DOD officials in evaluating DLA inventory management. For example, a trend of net loss adjustments in such areas as medical supplies and clothing may indicate potential theft or pilferage.

According to DOD officials the reasons for the differences in the data was because the ICE report includes data on subsistence items and material located at 56 military service managed storage sites, whereas the depot quarterly summaries do not. However, DOD officials told us that data in the ICE report satisfies their needs in evaluating DLA's inventory management.

In our opinion, DOD cannot adequately evaluate DLA's management based on the ICE report data because, unlike the military services, DLA ICE data is influenced not only by how well DLA manages the items in its depots but also by how well the services control DLA items at their storage sites. Non-DLA storage activities and the subsistence commodity would have had to experience a net gain adjustment of $81.1 million for the 2 years to offset the $37.4 million depot loss and report an overall net gain of 43.7 million on the ICE report. DOD management cannot determine from DLA's ICE reports where the losses and gains occurred and therefore cannot evaluate DLA material management.

ICE Report Record Accuracy Rate Excludes Variances for $800 or Less

DOD requires DLA's ICE report to include the record accuracy rate, which measures how often the accountable records and the on-hand material balances agree. Preliminary indications of problems in the inventory records can be obtained by looking at record accuracy rates. However, this ICE report inventory accuracy rate does not include records with gain and loss adjustments of $800 or less.

Because most of DLA's adjustments are $800 or under, excluding these adjustments, as called for by current DOD reporting requirements, does not fully present DLA's record accuracy. For fiscal year 1986, DLA's reported accuracy was 84.3 percent; however, 88 percent of its record adjustments were adjustments under the $800 criterion and were not included in this accuracy figure. It was not possible based on DLA data to calculate a record accuracy rate that included the 88 percent of adjustments under $800.

Sample Results Indicate Some Accuracy Problems

In order to develop an independent assessment of DLA inventory accuracy, we inventoried a statistically valid sample of items at DLA's Mechanicsburg depot. We then analyzed the results of our sample, using the following three measures of inventory accuracy:

- record accuracy, which indicated how often the inventory record and a physical count were in agreement;
- quantity accuracy, which indicated the quantity of units counted as a percent of the quantity shown on the records; and
- dollar accuracy, which indicated the dollar values counted as a percent of the dollar values shown on the records.

Our sample showed high overall inventory accuracy. However, the results indicate areas for management attention in record accuracy, controlled item accuracy, and accuracy within some commodity classes.

Record Accuracy Rate

As previously noted, DLA's reported 84.3 percent record accuracy rate does not include items with minor variances of $800 or less. Based on our sample, the record accuracy rate was 63 percent and ranged from 38.9 percent for medical items to 76.0 percent for electronics items.[5] We expected the record accuracy rate to be lower than DLA reported for two

[5]Our random sample included 454 items valued at $7 million and is projectable to the Mechanicsburg depot inventory universe of 167,000 items valued at $920.6 million. The 63-percent records accuracy rate is a weighted rate based on the number of our sample items in each commodity class and has a confidence level of plus or minus 9 percent.

reasons: (1) our sample included variances both under and over $800, and (2) the types of items DLA manages, such as assorted nuts and bolts and electronic connectors, are on hand in large quantities and experience a great deal of receipt and issue activity, which provides numerous opportunities to make errors in the records.

Considering that DLA stocks about 980,000 items with a unit price of $10 or less and that 87 percent of DLA's fiscal year 1985 and 1986 inventory adjustments were $800 or less, computing the record accuracy rate by using only major adjustments over $800 does not seem appropriate at DLA as the inventory accuracy problems tend to be minimized. For example, in fiscal year 1986, DLA reported that it had experienced 85,362 major variances on the 544,012 physical inventories that it conducted, resulting in a record accuracy rate of 84.3 percent. However, based on complete data on three commodities and partial data on others, DLA experienced at least 152,096 variances—major and minor. If all of these variances had been included in the computation of DLA's record accuracy, the rate would have been at most 72 percent. The accuracy rate reflects, to some extent, the fact that most of the inventories done were unscheduled and were therefore the result of a known or indicated problem. These inventories tend to lead to lower inventory accuracy rates when compared to results derived from scheduled inventories.

DOD recognizes the inadequacy of computing inventory record accuracy rates solely on the basis of major variances and has proposed a revision to chapter 7 of the Military Standard Transaction Reporting and Accounting Procedures to require the services and DLA to include all inventory variances in the computation of the inventory accuracy rate.

Quantity and Dollar Variances Indicate Problems With Certain Commodities

The quantity and dollar variances also indicate problems with certain DLA commodity classes. Our stratified sample showed a quantity accuracy rate that ranged from 85.3 percent to 99.2 percent with medical items having the lowest accuracy rate. Furthermore, sample results showed that the lower medical unit accuracy rate was caused almost exclusively by loss variances.

Our analysis by dollar accuracy showed a range of accuracy from 82.2 percent for medical items to 98.3 percent for industrial items. When projected to the universe of items stored at Mechanicsburg, this represents a total dollar variance of about $42 million. Overall, we estimate that the depot had $6.1 million less stock on hand than shown on its stock records.

While the quantity and dollar value accuracy rates are fairly high, a commodity-by-commodity analysis of our sample data disclosed some problem areas, especially in the medical area. Table 2.2 shows the projected record, quantity, and dollar accuracy rates by commodity based on the sample items we physically inventoried. DLA does not analyze inventory data in this manner, and therefore such data is not routinely available to DLA management.

Table 2.2: Comparison of Accuracy Rates by Commodity

	Accuracy rates (Percent)		
Commodity	**Record**	**Quantity**	**Dollar**
Construction	69.3	97.9	94.9
Electronics	76.0	99.2	96.9
General	42.3	97.2	92.6
Industrial	53.8	98.9	98.3
Medical	38.9	85.3	82.2
Clothing and Textile	68.1	86.6	96.5
Weighted Total[a]	**63.0**	**97.1**	**95.4**

[a]Weighted percentages with a 95-percent confidence interval of plus or minus

- 8.9 percent for record accuracy.

- 0.2 percent for unit accuracy.

- 3.6 percent for dollar accuracy.

We believe accuracy rates should be analyzed collectively; otherwise, management could be misled about where to place its emphasis. For example, all accuracy rates for medical items are relatively low; therefore, this area would appear to need management attention. Medical items in our sample included hypodermic needles, codeine, and surgical sutures. The general commodity class includes items such as film, batteries, and flashlights and also has relatively lower accuracy rates—which should be the basis for further management analysis and action.

Low Accuracy Rate for Controlled Items

Record accuracy rates for controlled items in our sample stored in vault and caged areas were about the same as the 63-percent rate for all items in our sample. The monetary and quantity accuracies of 98.8 percent and 98.6 percent, respectively, for vault-stored items were near the 100-percent accuracy one would expect for this type of controlled storage. The caged items, however, had lower accuracy levels—90.9 percent for dollar value and only 69.5 percent for quantity accuracy.

Our sample inventory included 188 controlled items that required either vault or cage storage, of which 105 were medical items. We found that 79 of these had on-hand balances that did not match record balances. Table 2.3 shows the results of our physical inventories of vault and cage area items.

Table 2.3: Results of Vault and Cage Physical Inventories at Mechanicsburg Depot

		Percentage accurate[a]		
Items inventoried	**Number**	**Record**	**Quantity**	**Dollar**
Vault:	67			
Items with matches	42	62.5	98.6	98.8
Items with gains and losses	25			
Gains	11			
Losses	14			
Cage:	121			
Items with matches	67	59.5	69.5	90.9
Items with gains and losses	54			
Gains	29			
Losses	25			

[a]Weighted percentages with a 95-percent confidence interval of plus or minus

- 10.5 percent for vault and 7.8 percent for cage (record accuracy).
- 0.2 percent for vault and 1.3 percent for cage (quantity accuracy).
- 2.7 percent for vault and 6.1 percent for cage (dollar accuracy).

Fifty medical items were included in the 67 vault storage items, and they accounted for 11 of the 14 vault loss inventory variances. There were 55 medical items included in the 121 cage storage items, and they accounted for 18 of 25 loss variances. Different types of hypodermic needles and syringes constituted 12 of the 18 medical item loss variances in the caged area.

Causative Research Can Be More Effective

DLA follows DOD policy of doing causative research primarily on inventory variances over $800. However, because of the types of items DLA manages, most of its inventory variances are under $800. Also, reports that identify errors and are needed to investigate reasons for variances were not being effectively used to correct the basic causes of problems, and follow-up to assess effectiveness of corrective actions was not taken.

DOD requires components to research inventory adjustments to determine the basic causes of inventory accuracy problems so that corrective action can be taken. DOD criteria for researching adjustments are as follows:

- All controlled items, excluding pilferable items under $2,500, require complete, causative research.
- Sample causative research is required for pilferable items under $2,500.
- All noncontrolled items over $16,000 require complete causative research.
- Sample causative research is required for items with adjustments between $800 and $16,000.

DOD does not require causative research on adjustments for noncontrolled items of $800 or less.

Most Inventory Variances Not Researched

The DOD criterion of not researching inventory adjustments for noncontrolled items of $800 or less does not seem appropriate for DLA because about 980,000 of the 1,874,000 items stored by DLA (52.3 percent) have a unit cost of $10 or less and are therefore likely to have low dollar value adjustments. As shown in table 2.4, 87 percent of DLA's inventory adjustments in the last 2 fiscal years were under the $800 criterion and therefore were less likely to be researched.

Table 2.4: Percentage of Adjustments $800 or Less for Fiscal Years 1985 and 1986

	Number of adjustments		
Supply Center	Total	Percent of adjustments $800 or less	$800 or less
General	65,211	53,384	82
Industrial	137,125	127,199	93
Electronics	30,354	29,263	96
Construction	122,157	99,794	82
Medical	15,741	12,201	78
Totals	**370,588**	**321,841**	**87**

During fiscal year 1986, DLA's supply centers reported 36,756 inventory adjustments for items stored at the Mechanicsburg depot. Causative research was performed on 777 of the adjustments. Even though the value of individual adjustments may be relatively small, when there are so many and the reasons are not identified, potential corrective measures cannot be evaluated and incidents of fraud, waste, and abuse could

go undetected. In commenting on a draft of this report, DOD said the criteria for conducting causative research will be examined in an upcoming study of its Inventory Control Program.

DLA performs causative research, as required by DOD, on adjustments for controlled items, including those that are $800 or less. Our sample indicated that controlled items constitute less than one-half of one percent of the items DLA manages. At Mechanicsburg, however, we found many items that, although not classified as pilferable items, appear to fit DOD's definition of a pilferable item; i.e., the item has a ready resale value, history of losses, or application for personal use. For example, Mylanta, Children's Tylenol, and Gelusil were not coded as pilferable items although because of their application for personal use and storage in uncontrolled areas, they had a high potential for theft.

As shown in table 2.1, during fiscal years 1985 and 1986, DLA experienced a $4.0 million net loss variance for medical items. Because 78 percent of DLA's medical item adjustments during fiscal years 1985 and 1986 were under $800, they would not be researched unless they were controlled items.

Missing Causative Research Reports

Causative research reports prepared by DLA's supply centers to inform the depots of the reasons for inventory variances were not always available at the Mechanicsburg depot for use in correcting identified inventory problems. The Mechanicsburg depot had only 25 of 48 fiscal years 1985 and 1986 quarterly causative research reports prepared by the five supply centers. The responsible Mechanicsburg official advised us that the supply centers probably had not issued the reports because no errors were found during those quarters. The depot therefore did not follow up with the centers to obtain copies of the missing reports.

The supply centers provided evidence indicating that they had issued some of the missing reports to the Mechanicsburg depot. The centers subsequently provided 16 missing reports; however, they could not find the remaining 7. Because neither the center nor the depot had established a control file of issued and received reports, we were unable to determine whether the depot received them or the centers actually sent all the missing reports.

The following are examples of some of the missing reports and the types of information on inventory variances that could have been used by

depot personnel to help in investigating reasons for the variances and corrective actions needed.

- DISC's fourth quarter, fiscal year 1985, report showed that 52.9 percent of Mechanicsburg's inventory variances on industrial items was caused by erroneous denials (initially material could not be found to fill an order but was subsequently located) and failure to post receipt and issue documents.
- DISC's first quarter, fiscal year 1986, report showed that 40 percent of the inventory variances on industrial items was caused by erroneous inventory counts by the depot.
- DPSC's first quarter, fiscal year 1986, report for the medical items showed that 63 percent of the variances was caused by the depot making erroneous denials, erroneous inventory counts, and erroneous postings.
- DPSC's second quarter, fiscal year 1986, report for medical items showed that 71.6 percent of the variances was caused by the depot making erroneous denials, erroneous inventory counts, and erroneous postings.

Follow-Up Needed to Assess Effectiveness of Corrective Action

Quarterly supply center causative research reports received by the Mechanicsburg depot were not being analyzed as directed by DLA Headquarters.

The depot's Inventory Control Branch is responsible for providing other branches and divisions with copies of the research reports to use in their investigations of inventory variances. Upon completion of their investigations, the branches and divisions are required to forward the results to the Inventory Control Branch where the findings and recommendations are to be consolidated in a final report to depot management. Branches and divisions do not provide the Inventory Control Branch with the results of their research on reasons for the erroneous transactions because the Branch is not requiring them to do so. Adding to this problem is the fact that the Inventory Control Branch does not follow up to determine the operating groups' findings and recommendations because the Branch has limited staff.

Physical Security Still Needs to Be Improved

In our May 1986 report on inventory management, we pointed out that physical security over DOD inventories needed improvement. We believe the Mechanicsburg depot still needs to improve its physical security over material. We found that (1) physical security problems noted by Mechanicsburg security officials have not been corrected in a timely

fashion, (2) pilferable items are being stored in areas that do not meet the minimum physical security standards, and (3) prescription and non-prescription drugs, which are highly desirable, are stored in uncontrolled areas that do not provide any special protection.

Timely Corrective Action Needed

During our sample inventory, we observed pilferable items stored in opened boxes in an unlocked refrigerated area. Depot officials had been aware of this situation since July 1986. The July 1986 minutes of the depot quarterly Crime Prevention/Detection and ADP Security Council meeting indicated that pilferable items were being improperly stored in an unlocked refrigerated area. In May 1987, a depot security official advised us that the refrigerated area still did not meet the required security requirement; however, a work order had been issued to bring it into compliance with security requirements for the open storage of pilferable items.

A number of other security problems had been identified by depot security. Our review of the minutes of calendar year 1986 and the first quarter, fiscal year 1987, Council meetings disclosed that depot security identified the following recurring situations that could foster pilferage:

- open doors and windows in warehouses;
- erroneous security code data on depot reports, which could cause controlled items to be improperly stored; and
- items such as batteries and panty hose improperly stored.

The Deputy Commander of the Mechanicsburg depot, expressing his displeasure that problems were not being addressed and corrected as quickly as possible, has instructed depot officials to correct identified problems expeditiously and to forward status reports to him as actions are taken and completed.

Pilferable-Type Items Improperly Stored

DLA regulation 4145.11, pertaining to the safeguarding of pilferable material, requires that when containers are opened for issue, remaining contents should be moved to caged storage or the container should be resealed securely and marked with the current amount of contents. During our February 1987 inventory, we found that this was not being done. Pilferable items outside the caged area were in loose containers and included spark plugs and batteries. We were informed by depot officials that this condition existed because of the lack of caged storage space.

The caged storage area was located in building 208 in bay 1. In order to comply with security regulations and to provide additional protection to pilferable items stored outside the caged area, the depot Commander designated bays 1 and 2 as limited access areas. However, the doors to bays 1 and 2 must remain open because the automated cart system runs through these bays. As a result, these bays do not currently meet physical requirements of DLAR 4145.11 for the storage of pilferable items in open containers. The Commander has designated the entire building a controlled area for the storage of pilferable items and was renovating the building to meet the requirements of DLAR 4145.11.

The depot recognizes it has potential security problems in storing pilferable-type items. The volume of items being received by Mechanicsburg and space limitation necessitate the storage and issue of material from outside warehouse ramps. Also, because of limited installation parking, privately owned vehicles were allowed to park between and adjacent to storage warehouses.

Because storing material outside presents an opportunity for pilferage, the depot's Security Council addressed this issue. The Security Council observed that boxes were not being resealed after items were picked for shipment and items being stored outside were pilferable-type items. The Council recommended that consideration be given to the nature of items before storing them outside; that is, large, heavy items should be stored outside and small, easily moved items should be stored inside.

Prescription and Nonprescription Drugs Stored in Uncontrolled Areas

During our review, we found that many medical items, including prescription and nonprescription drugs, were stored in uncontrolled areas. These items had not been designated as pilferable material by either the supply center or depot. Pilferable items are those that have (1) a ready resale value, (2) a history of unexplained losses or known theft, and (3) civilian utility or application as to personal possession and are, therefore, especially subject to theft. Although we did not analyze each medical item to determine if any meet the pilferable criteria, we believe that, because Mechanicsburg has experienced net loss adjustments over the last 2 fiscal years for medical items, such items should not be stored in uncontrolled areas. Table 2.5 shows examples of the types of drugs stored in uncontrolled areas that are susceptible to theft and that DLA needs to evaluate to ensure that they are correctly classified.

Table 2.5: Examples of Drugs Stored in Noncontrolled Area

Prescription	Nonprescription
Belladonna with phenobarbital	Anusol
Theodur	Aspirin
Clinoril	Children's Tylenol
Tagamet	Elixir
Tetracycline	Ascripton
Thorazine	Mylanta
Penicillin G potassium	Afrin Nasal Spray
	Gelusil II

Conclusions

DOD decisionmakers need accurate inventory information on which to make effective, efficient, and economical budget and supply management decisions. Accurate information depends on effective inventory control, which requires taking physical inventories, researching inventory variances, and accurately reporting inventory control effectiveness. Also, protection of inventory items from loss due to theft requires sound physical security. Otherwise, there can be little assurance that inventory losses are merely due to bookkeeping or other administrative errors.

DLA has identified inventory accuracy problems and has taken some actions to correct many of the problems. Although our sample showed overall high inventory accuracy, improvements are needed in certain problem areas. We believe statistical samples, stratified by commodity type and collectively analyzed for record, unit, and dollar measures, can provide management better inventory accuracy data on which to take actions.

DLA's inventory control effectiveness reports sent to DOD do not separate inventory gains and losses at DLA-managed depots from inventory performance data on DLA material located at other military service facilities. Consequently, DOD management does not have an independent picture of DLA inventory management performance. Also, DOD does not require the reports to include data on most inventory variances under $800 when computing record accuracy rates, which include most of DLA's variances; therefore, this rate does not reflect DLA's actual record inaccuracies.

DLA manages a lot of low-value, consumable type items. Variances of $800 or less represented 87 percent of DLA's 1985 and 1986 adjustments.

Therefore, DOD criteria that does not require causative research on non-controlled item variances of $800 or less may not be appropriate for DLA and may need to be reassessed. We believe that variances of $800 or less should be researched on a sample basis to determine if there are trends or systemic concerns that need attention. Improvements are also needed at the depot level where causative research reports identifying errors for corrective action were missing and follow-up action was not taken.

At the Mechanicsburg depot, physical security over sensitive and pilferable-type items needs to be improved because identified problems, such as storing drug items in uncontrolled areas and improper storage of pilferable items, had not been corrected.

Finally, based on our review, we believe it was premature for DLA to assess its actions on correcting the inventory management weakness it reported in its fiscal year 1986 Financial Integrity Act report as complete.

Recommendations

To provide DOD decisionmakers with more accurate, complete, and appropriate data, we recommend that the Secretary of Defense change its policy regarding inventory effectiveness reporting to require DLA's inventory control effectiveness reports to identify inventory performance data for its own depots separately from data of military service sites at which DLA material is stored.

Further, to ensure that physical inventories are representative and that causative research is an effective tool for identifying and correcting recurring causes of inventory variances, we recommend that the Director, Defense Logistics Agency, require that

- statistical samples of items be taken by commodity type and that the record, quantity, and dollar value accuracy indicators be collectively analyzed to identify areas for further analysis;
- its planned reassessment of the causative research criteria include a determination whether a sample of adjustments under $800 should be researched annually; and
- centers and depots establish controls for the proper distribution of quarterly causative research reports and follow up on corrective actions for identifying inventory variances.

Additionally, we recommend that the Director require the Mechanicsburg depot to take immediate action to correct known security problems and emphasize the need to properly store pilferable-type items.

Also, the Director should consider including inventory accuracy again as a material weakness in the next internal controls annual assessment.

Agency Comments and Our Evaluation

We obtained official DOD oral comments on a draft of this report. DOD concurred in our recommendations regarding statistical sampling by commodity type for physical inventories, distribution of quarterly causative research reports, and the need for improved physical security at the Mechanicsburg depot. DLA is implementing a statistical sampling feature as part of its Automated Information System for use at DLA depots. The DLA Depot Operational Review and Technical Assistance Team, which visits each depot each year, will examine controls and use of quarterly causative research reports as a special interest item during its visits. Additionally, physical security standards are currently under revision, and actions have been taken to correct problems cited in our report.

DOD did not concur with the recommendations as written in our draft report regarding inventory accuracy data compiled for the ICE report, researching variances of $800 and under, and identifying inventory management as a weakness in DLA's next internal controls assessment. GAO considered DOD's comment in framing its final recommendations.

In our draft report, we had proposed that DLA inventory accuracy data compiled for the ICE report be consistent with data in its depots' reports. DOD said that the inventory adjustment data available at the depots is fully consistent with data compiled for the ICE report even though the data is derived from two different sources. The difference occurred because the ICE report includes adjustment data on subsistence items and material located at 56 military service storage sites, whereas the depot quarterly summaries do not. Based on data later provided by DLA, we were able to determine that the difference in the reports was attributable to reported inventory gains for the subsistence commodity and non-DLA activities.

Unlike the military services, DLA's reported ICE data is influenced not only by how well DLA manages the inventories under its control at its depots but also by how well the services manage the large quantities of DLA material under their control at their storage activities. We believe

that data in DLA's ICE report needs to be more informative if it is to be used effectively by DOD to evaluate DLA inventory management. We have revised the report to include the reasons why the reports differ and to recommend a change in ICE reporting requirements regarding DLA inventory data.

While DOD did not agree with the proposal in the draft report to do causative research on a sample of variances of noncontrolled items of $800 and under, it concurred in the intent of the recommendation—to perform sufficient causative research to gather reliable data about error causes and take corrective actions as a result. DOD noted that it was unclear that such a practice would improve the reliability or utility of causative research data being gathered; however, it pointed out that its study of the DOD Inventory Control Program will examine the criteria for conducting causative research. Since such an examination would address our concern about totally ignoring adjustments of noncontrolled items of $800 or less, we have revised our recommendation to recognize DOD's upcoming study.

Although DOD nonconcurred in our draft report proposal regarding DLA's reporting inventory accuracy as an area of material weakness, it did concur that the Director, DLA, should, as is usual practice, consider including this in its annual assessment of internal controls. We have, therefore, revised our recommendation to incorporate language suggested by DOD.

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