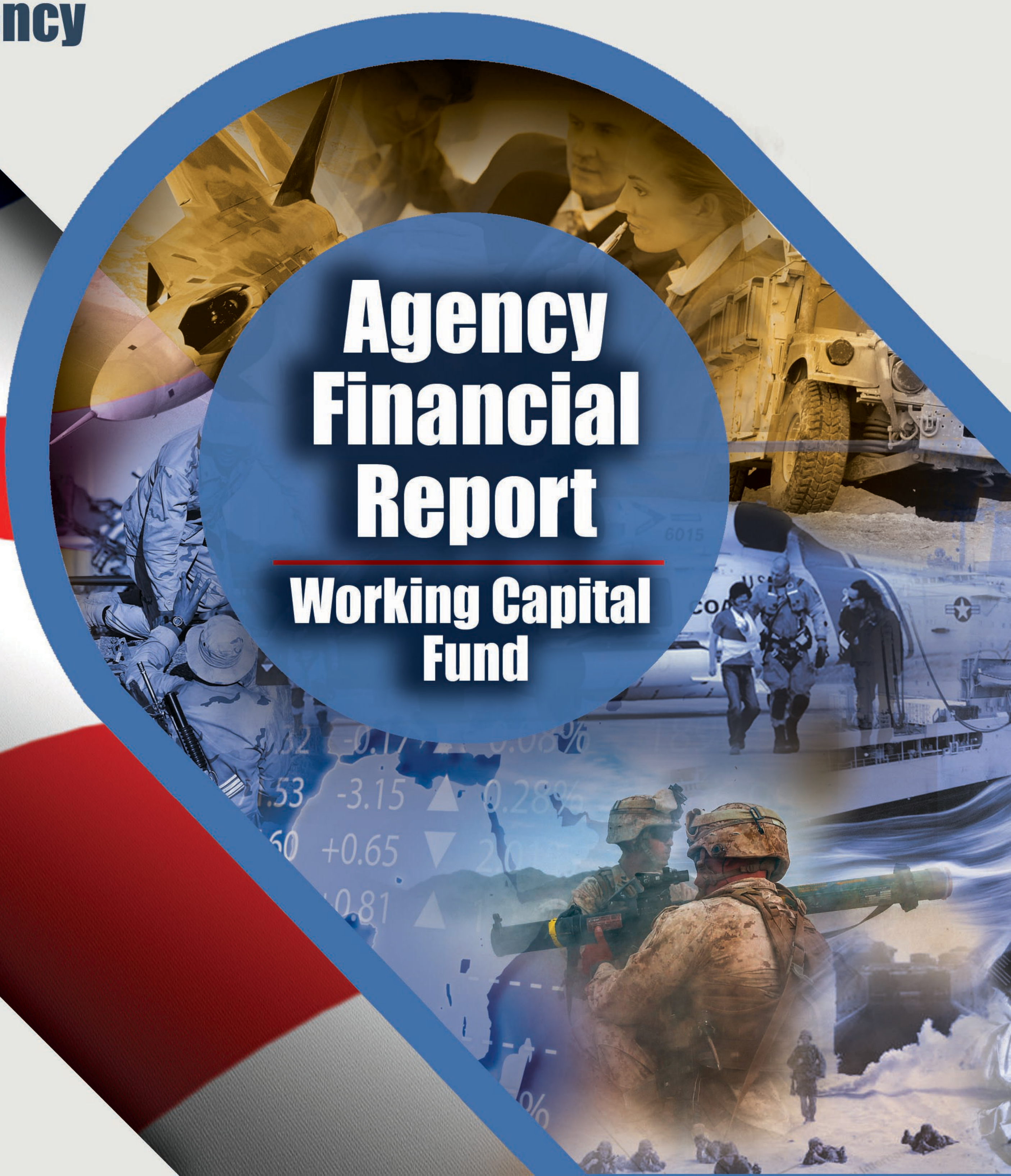
Defense Logistics Agency

FISCAL YEAR 2018 (Unaudited)

Agency Financial Report

Working Capital Fund



DEFENSE LOGISTICS AGENCY WORKING CAPITAL FUND AGENCY FINANCIAL REPORT

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Defense Logistics Agency
Working Capital Fund
Fiscal Year 2018 Agency Financial Report

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Message from the Director

On behalf of the Defense Logistics Agency (DLA), I present the Fiscal Year (FY) 2018 Agency Financial Report. This report provides an overview of our programs, accomplishments, challenges, and management's accountability for the resources entrusted to us by the American Public and our partner agencies. DLA is fully committed to upholding that trust by improving its ability to provide transparency and report accurately the operating results of the DLA's complex and important mission.

DLA, as the nation's combat logistics support agency, has a proud history of supporting the Warfighter, providing effective logistics support to the operating forces of our Military Services at the lowest possible cost to the taxpayer. As we continue to improve our performance, we can devote more resources to our Military Services to accomplish their critical missions to defend the nation. To accomplish our goals of delivering world-class support to the Warfighter and of continued accountability, the Agency has focused its resources on seven Lines of Effort:

- ***Warfighter First:*** *Strengthen Service and Combatant Command Readiness and Lethality*
- ***Global Posture:*** *Prepared for Immediate Action*
- ***Strong Partnerships:*** *Leverage the Joint Logistics Enterprise, Interagency, Industry, and Partner and Allied Nations*
- ***Whole of Government:*** *Support to the Nation*
- ***Always Accountable:*** *Assured Supply Chain, Financial and Process Excellence*
- ***People and Culture:*** *The heart of everything we do. If you take care of your people, the mission will happen*
- ***Enterprise Enablers:*** *Technology, Innovation, and Data Management*

Our Independent Public Accounting firm issued a Disclaimer of Opinion on DLA's 2018 Working Capital Fund (WCF). DLA conducted its assessment of the effectiveness over internal controls in accordance with the OMB Circular A-123, *Management's Responsibility for Internal Control*. Based on the assessment, DLA management was unable to provide assurance that the internal controls were operating effectively. The related material weaknesses are the impediments to obtaining an unqualified audit opinion, and positive assurance over internal controls.

DLA has made improvements on the path to correct our material weaknesses. We are committed to achieving auditability and are actively remediating open audit findings and internal control weaknesses. DLA will develop a comprehensive management strategy to address DLA material weaknesses, including organizational capabilities, underlying business processes, accounting challenges, and non-compliant financial systems. DLA is preparing comprehensive corrective action plans to address internal control weaknesses and audit findings.

I am confident in our abilities to meet the challenges with accountability, while continuing to be the standard-bearer for joint logistics and acquisitions. With our agile and professional workforce as our solid foundation, we will continue to be the Nation's best combat logistics support Agency.

DARRELL K. WILLIAMS
Lieutenant General, USA
Director

An aircrew from the California Air National Guard's 163rd Attack Wing flies an MQ-9 Reaper remotely piloted aircraft during a mission to support state agencies fighting the Mendocino Complex Fire in northern California, August 4, 2018.
California Air National Guard photo by Senior Airman Crystal Housman.

Management's Discussion and Analysis (Unaudited)

The ***Management's Discussion and Analysis (Unaudited)*** section is required supplementary information to the Working Capital Fund financial statements and provides a brief, high-level overview of the Defense Logistics Agency.

The ***Mission and Organizational Structure*** section describes the Defense Logistics Agency's organization, its missions and goals, and provides an overview of our Defense Logistics Agency Commands.

The ***Performance Goals, Objectives, and Results*** section provides a summary of the Working Capital Fund's mission, goals, objectives, results, and future initiatives to strengthen the Working Capital Fund efforts in supporting the DoD objectives and missions.

The ***Analysis of Financial Statements and Stewardship Information*** section provides a summary of Working Capital Fund financial data explaining the major sources and uses of funds and provides a quick look at our Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and Limitations of Financial Statements.

The ***Analysis of Systems, Controls, and Legal Compliance*** section provides the Director's Assurance Statement related to the Federal Managers' Financial Integrity Act and the Federal Financial Management Improvement Act. This section also describes the Working Capital Fund's efforts to address our financial management systems to ensure systems comply with applicable accounting principles, standards, and requirements and with internal control standards.

Mission and Organizational Structure

The Defense Logistics Agency (DLA) reports to the Office of the Under Secretary of Defense (OUSD) for Acquisition and Sustainment through the Assistant Secretary of Defense for Sustainment. DLA provides support around the clock and around the world to meet the needs of America's Armed Forces and other designated customers in times of peace, national emergency, and war. America's national defense strategy depends on DLA's support to feed, clothe, fuel, medicate, treat, and sustain U.S. and many allied nations' troops. DLA supports Department of Defense (DoD) objectives and missions with involvement in the full range of military operations from participation with multi-national forces engaged in large-scale combat operations, weapons and spares provisions, peacekeeping efforts, and emergency support to humanitarian assistance.

DLA's Mission, Vision, and Values

Mission	Vision	Values
Sustain Warfighter readiness and lethality by delivering proactive global logistics in peace and war.	We are the Nation's Combat Logistics Support Agency …Global, Agile, and Innovative; Focused on the Warfighter First!	Leadership, Professionalism, and Technical Knowledge through Dedication to Duty, Integrity, Ethics, Honor, Courage, and Loyalty.

DLA Working Capital Fund (WCF) employs approximately 25,400 civilian personnel, 530 active duty military personnel, and 660 reserve personnel who operate a global enterprise in 28 countries and 48 states.

DLA manages nine supply chains and supports more than 3,750 weapon systems. The nine supply chains are: Aviation Systems, Land Systems, Maritime Systems, Fuel/Energy, Subsistence, Medical, Clothing and Textiles, Construction and Equipment, and Industrial Hardware. Agency leaders are committed to the continuous assessment and transformation of the organizational culture, size, structure, and alignment through enterprise integration and partnering with the private sector. Organizing as a single, integrated business enterprise enables DLA to focus on supporting the DoD's supply chains, enhancing the Armed Forces' readiness, and providing for the Warfighter during contingency operations.

DLA chose to produce an Agency Financial Report (AFR). The DoD produces an Annual Performance Report (APR) for all its components (including DLA WCF) and will include its Fiscal Year (FY) 2018 APR with its Congressional Budget Justification. All information within this report pertains to the DLA WCF unless specifically stated otherwise.

The following "Who's Who in DLA" chart represents DLA leadership Agency directors, J / D Code organizational heads, and Major Subordinate Command (MSC) heads. The J and D Codes are function codes used in DoD to identify the type of work performed within DLA.

Figure 1, DLA Organizational Chart

Defense Logistics Agency – Enterprise J/D Codes

DLA HUMAN RESOURCES (J1) provides the full range of human resource services, both policy and operational, for DLA's civilian and active duty military employees. DLA Human Resources recruits, hires, trains, and sustains a mission-ready workforce for DLA and our Human Resources customers, using world-class policies, processes, programs, and tools.

DLA LOGISTICS OPERATIONS (J3) is responsible for the end-to-end supply chain management of DLA's supply chains, providing logistics and materiel process-management policy, guidance, and oversight. J3 integrates strategic, operational, and tactical perspectives, as well as command and control functions for contingency operations and logistics supply chain planning. J3 maximizes the readiness and logistics combat power by leveraging enterprise solutions to support DLA's global customer base.

DLA INFORMATION OPERATIONS (J6) as DLA's knowledge broker, provides comprehensive, best practice Information Technology (IT) support to the DoD/DLA Logistics Business Community, resulting in customer support, efficient and economical computing; data management; electronic business; telecommunication services; and key management, and secure voice systems for DoD, DLA, and geographically separated operating locations. The Director of

Information Operations also serves as DLA's Chief Information Officer (CIO). DLA Information Operations also manages DLA's Research and Development (R&D) IT program.

DLA ACQUISITION (J7) is responsible for planning, organizing, directing, and managing the procurement and contract administration functions for DLA acquisition in support of both internal operations and other supported activities. The Director of DLA Acquisition also serves as the Agency's Component Acquisition Executive. DLA Acquisition provides oversight of DLA Contracting Services Office.

DLA FINANCE (J8) is responsible for obtaining and allocating resources; analyzing execution; and providing fiscal guidance and advice to support the Agency, its business areas, and its Major Subordinate Commands (MSCs) in accomplishing DLA's mission. DLA Finance prepares the AFRs and guides DLA in its Audit Remediation efforts. The Director of Finance also serves as DLA's Chief Financial Officer (CFO).

DLA JOINT RESERVE FORCE (J9) provides DLA with trained, ready, and available reservists from the Army, Air Force, Navy, and Marine Corps for worldwide contingency operations and support of ongoing operations, surge requirements, and logistics planning.

DLA OFFICE OF SMALL BUSINESS PROGRAMS (DB) provides small business advocacy and promotes small business utilization to strengthen the competency, capability, and commitment of the industrial base that fulfills DLA's mission as the Nation's combat logistics support Agency. The DLA Office of Small Business Programs is responsible for implementation of the Procurement Technical Assistance Program to expand the number of businesses capable of participating in contracts with DoD, other Federal agencies, state and local governments, and government prime contractors.

DLA GENERAL COUNSEL (DG) DLA General Counsel delivers professional, candid, and independent legal advice and services to the DLA.

DLA COMMAND CHAPLAIN (DH) serves as the program manager for religious support logistics. This office provides the DLA Director and the staff a clear picture of workforce morale as affected by religion, ensuring the free exercise of religion to support the Warfighter and the employees in the workplace at DLA.

DLA INSTALLATION MANAGEMENT (DM) provides enterprise-wide Agency policy, program, and worldwide operational support in environmental management; safety and occupational health; installation management; public safety; forms and policy management; and morale, welfare, and recreation for DLA.

DLA EQUAL EMPLOYMENT OPPORTUNITY AND DIVERSITY OFFICE (DO) provides DLA senior leadership, staff, and subordinate commands enterprise-wide respondent and subject matter expertise on all Equal Employment Opportunity (EEO) Compliance oversight, Affirmative Employment and Diversity and Inclusion.

DLA PUBLIC AFFAIRS (DP) provides public affairs support, communication strategy development, and engagement guidance to the DLA senior leadership, staff, and subordinate commands. The DLA Public Affairs office develops and administers internal news and information; manages DLA's online web presence (http://www.dla.mil); interacts with external media; serves as DLA official spokesperson; manages DLA social media and public engagement policies; and develops programs that communicate DLA's role as a combat support Agency that adds value to the Defense Department, Military Services, Combatant Commands, and the American people.

DLA TRANSFORMATION (DT) manages the DLA's strategic plan, executive governance forums, and the Agency-wide deployment of Enterprise Process Management, Continuous Process Improvement, Enterprise Organizational Alignment, and Enterprise Policy Management programs.

DLA OFFICE OF THE INSPECTOR GENERAL (OIG) coordinates and synchronizes U.S. Government Accountability Office (GAO) and Department of Defense Office of the Inspector General (DoDIG) audits with all DLA components; tracking, monitoring, and assessing the implementation of audit corrective actions and communicating completion results. They sustain strategic engagement with the Defense Counsel on Integrity and Efficiency and their subcommittees, as well as relationships with DoDIG Criminal Investigative Services, Military Criminal Investigation Services, and other law enforcement agencies. DLA OIG also conducts administrative investigations and crime vulnerability assessments that align with Agency risks and strategic goals. The DLA OIG internal audit plan is derived from DLA's Enterprise Risk Management (ERM) efforts, and also encompasses external audit projects derived from GAO's high risk list.

DLA MAJOR SUBORDINATE COMMANDS

DLA AVIATION, headquartered in Richmond, Virginia, is the primary source for repair parts and operating supply items for more than 1,750 major weapon systems. The DLA Aviation supply chain provides mapping, kitting, chemical, petroleum packaging, gases, and cylinder items to the Military Services. In addition, DLA Aviation provides engineering, sustainability, ozone-depleting substances reserve, and industrial plant equipment services.

DLA DISPOSITION SERVICES, headquartered in Battle Creek, Michigan, has 1,407 civilians and 13 active duty military in a global network of 103 field locations in 15 countries, 2 territories, and 42 states. DLA Disposition Services receives excess, obsolete, and unserviceable (EOU) DoD property and provides ultimate disposal services through reutilization, transfer, donation, and sales. Property not reutilized within DoD is available for transfer to other Federal agencies or for donation to authorized non-profit organizations or state and local governments. Property not reused, transferred, or donated is either competitively sold or disposed of in an environmentally safe manner. DLA Disposition Services also arranges for the worldwide disposal of hazardous waste in compliance with laws and regulations.

DLA DISTRIBUTION, headquartered in New Cumberland, Pennsylvania, is responsible for the receipt, storage, issuance, packing, preservation, and transportation of items worldwide. It operates a network of distribution centers around the world that provide timely and quality support to the Warfighters. Their Global Stock Position Plan ensures rapid distribution of critical military items. DLA Distribution's overseas distribution operations are located in Europe, Middle East, and Pacific Asia regions.

DLA ENERGY, headquartered in Fort Belvoir, Virginia, serves as the DLA's executive agent for the bulk petroleum supply chain. DLA Energy's business includes:

- Selling petroleum and aerospace fuels,
- Arranging for petroleum support services,
- Providing facility/equipment maintenance on fuel infrastructure,
- Performing energy-related environmental assessment and cleanup,
- Storing and transporting for bulk and aerospace products, and
- Performing quality surveillance functions for petroleum for the Military Services, as well as for the privatization of their utility systems.

DLA LAND AND MARITIME, headquartered in Columbus, Ohio, is the primary source for repair parts for DoD weapon systems. The DLA Land and Maritime supply chains support U.S. Army, U.S. Navy Surface and Subsurface, and U.S. Marine Corps customers through dedicated customer relations, while working with numerous suppliers to fulfill requirements for assigned stock classes across the DoD. Furthermore, the DLA Land and Maritime supply chains provide logistical services directly to Army and Marine Corps industrial sites and Navy shipyards.

DLA TROOP SUPPORT, headquartered in Philadelphia, Pennsylvania, is DLA's lead center for troop and general support. DLA Troop Support is responsible for managing food, clothing, medical, construction and equipment, and general and industrial supplies worldwide. DLA Troop Support has the following supply chains: Subsistence, Clothing & Textile, Construction & Equipment, Medical, and Industrial Hardware.

Figure 2, Locations of the Major DLA Offices

Performance Goals, Objectives, and Results

This Performance Goals, Objectives, and Results section provides a summary of DLA's core mission and vision, critical imperatives, key Lines of Effort (LOEs) with goal-oriented objectives, and forward-looking initiatives to strengthen DLA's efforts in sustaining Warfighter readiness and our Nation's responsiveness. The key initiatives that have specific Director's emphasis in DLA's Strategic Plan are shown in the key LOEs below.

Figure 3, Lines of Effort and Objectives

The following is a discussion of FY2018 results and outcomes for DLA and its WCF program and activities as aligned with the LOEs presented in DLA's 2018-2026 Strategic Plan.

LOE #1: Warfighter First

DLA's number one priority is sustaining the full range of military operations in an increasingly complex global environment while delivering innovative and responsive solutions to Warfighters first, DoD components, and our other valued customers.

Nuclear Enterprise Weapon System: DLA supported Service efforts to accurately code and map parts to Nuclear Enterprise (NE) weapon systems, including Nuclear Command and Control Communications (NC3) and Integrated Threat Warning/Attack Assessment systems.

Readiness Dashboard: DLA published a Readiness Dashboard and initiated weekly Service and Combatant Commanders readiness-focused updates. As these metrics were validated and refined, DLA continued automating development for metrics and detail files in the Enterprise Data Warehouse (EDW). Now there are actionable, informative, and timely DLA metrics aligned with Service readiness views complete with actionable detail files. These metrics enable timely and better-informed decisions, supporting the Logistics, Materiel, and Readiness (LM&R) goal of increasing materiel availability for weapons systems.

Supply, Storage, and Distribution: DLA provided support and analysis for the LM&R Transform Sustainment goal of moving Supply, Storage, and Distribution (SS&D) functions to DLA and, for sites where DLA performs SS&D, achieved an increase in materiel availability for weapons systems in three years. This initiative contributes to the Office of the Secretary of Defense (OSD) Logistics Reform goal of ensuring a reduction in weapon system and equipment availability cost.

Counterfeit and Non-Conformance Parts: DLA strengthened its capability to identify and prevent counterfeit and non-conformance parts from entering DLA supply chains by enhancing current business processes and screening methods, and by implementing new technical and system solutions. The cumulative effect of DLA's combating counterfeiting capability prevented suspect counterfeit parts from being issued to the Warfighter. It also facilitated the suspension and debarment of numerous suppliers from doing business with DoD and DLA, and the arrest of several suspect actors.

Predictive Technology: DLA has procured a tool that will increase the use of automated financial systems, tools, and applications to reduce cost and increase productivity. DLA is on track to deploy this tool fully. DLA is also developing flexible pricing options that allow customers to choose the level of performance and service that best meets their operational and affordability requirements. DLA plans to produce a report describing potential flexible pricing options and recommendations by December 2018.

Warfighter Trust: DLA's continual goal is to earn the Warfighter's trust as the Nation's combat logistics provider by understanding our customers' current requirements and anticipating their future needs. In order to meet this goal, DLA has:

- Established and tracked Alternative Lead-Time (ALT), Production Lot Testing (PLT), and On-time Delivery (OTD) metrics. DLA plans to implement new ALT metrics in FY2019 to minimize ALT. Additionally, DLA is revising the process for monitoring the system data analysis for OTD/Time-Definite Delivery (TDD) improvement.
- Conducted cost summits on a bi-annual basis.

LOE #2: Global Posture

DLA's logistics presence and posture must enable the nation's ability to protect its global interests. DLA will position resources for rapid use, build more deployable capabilities, and strengthen our partnerships using integrated logistics and contracting services.

Operational Contract Support: DLA sustained and improved the use of Operational Contract Support (OCS) capability to meet Combatant Commanders (Geographic Combatant Commands and United States Special Operations Command) requirements through the Service Components and Theater Special Operations Commands (TSOCs). OCS is at a critical juncture and remains on the GAO-17-317, *Biennial General Accounting Office High Risk Report*.

Global Logistics Support Capability: DLA is developing a Global Logistics Support Capability (GLSC) to provide greater depth for DLA core capabilities in both humanitarian aid/disaster relief and conflict.

Joint Reserve Force: DLA designed, staffed, trained, equipped, and deployed a new Joint Reserve Force Deployable Support Team capability. DLA doubled Reserve participation in joint exercises in cooperation with DLA Logistics Operations and MSCs.

LOE #3: Strong Partnerships

DLA's mission requires close collaboration and strong relationships with critical stakeholders, such as the Joint Logistics Enterprise, other government partners, suppliers, and our allies.

Center of Excellence for Performance-Based Logistics: DLA established a Center of Excellence for Performance-Based Logistics (PBL), providing product support and commodity solutions to DoD and interagency partners. This initiative will establish a DLA capability by FY2020 to develop, execute, and deliver performance-based arrangement solutions.

F-35 Product Support Provider: DLA is working to reduce F-35 enterprise costs and improve fleet readiness by developing sustainment options, developing strategic partnerships, and becoming an F-35 Product Support Provider (PSP) in disposition, cataloging, and transportation. To serve as the disposition PSP, DLA is working with the F-35 Joint Program Office (JPO) to demonstrate disposal of F-35 materiel at international partner/Foreign Military Sales locations. DLA engages with the JPO and Lockheed Martin to order common items from DLA as a step into organic sustainment. In its bid to serve as the Outside the Continental United States (OCONUS) Distribution and Transportation PSP, DLA is collaborating with United States Transportation Command to provide transportation coordination, global In-Transit Visibility, and customs capability for parts shipment. This effort included establishing Transportation Account Codes to facilitate Lockheed and Pratt & Whitney F-35 part shipments via the Defense Transportation System.

Support to Major Acquisition Programs: DLA continued to enhance its partnerships with DoD and Department of Homeland Security (DHS) major weapon systems acquisition programs. The ultimate goal is to engage early in the acquisition process to lower lifecycle costs and assist with determining the most efficient Life Cycle Logistics solutions. DLA is helping to shape the Integrated Logistics Support Plans of our partners through active participation on their Integrated Logistics Support Management Teams (ILSMT). DLA is actively engaged in ILSMT planning in support of the Coast Guard Offshore Patrol Craft and Polar Ice Breaker.

Small Business Goals: DLA's goal was to maximize efforts to exceed DoD and other governmental policy goals and objectives, including but not limited to Small Business, Competition, and AbilityOne programs.

Industry Partnerships: DLA works with industry to ensure a capable defense industrial base and maintain a secure and resilient supply chain. To meet this goal, DLA:

- Published a comprehensive Supplier Engagement Strategy in March 2018;
- Established an Enterprise Supplier Advocacy Network in March 2018;
- Held Industry/DLA Day with select DLA suppliers in September 2018;
- Expanded DLA acquisition professionals' understanding of what motivates and drives industry through the development of DLA-specific industry-focused courses with the University of Virginia and the University of North Carolina.

<u>LOE #4: Whole of Government</u>

DLA's global network and expertise in supply chain management can improve the efficiency and increase the effectiveness of our Whole of Government (WOG) partners. Collaboration ensures a healthy, viable base of suppliers able to surge when needed. Working alongside these WOG partners in domestic and international operations, DoD and DLA strengthen their ability to serve national interests.

Crisis Response Team Strategy: In conjunction with WOG partners, DLA developed, coordinated and exercised a crisis-response team strategy. DLA provided efficient and effective supply chain support to the National Response Framework and developed a rapid interagency response capability tailored to Continental United States and OCONUS response scenarios. DLA has institutionalized response capabilities in support of the WOG LOE through the following accomplishments:

- Developed WOG contingency response strategy; and
- Executed its crisis response team twice in FY2018 to include real world responses to Hurricane Lane and Hurricane Florence.

<u>LOE #5: Always Accountable</u>

Trust and confidence in DLA is born from ethical behavior, reliability, and transparency. Cost-consciousness, auditability, innovation, risk assessment and mitigation, and sound business processes are the foundation of this trust. DLA holds partners and suppliers to these same high standards.

Cost Consciousness: DLA promotes a cost-conscious culture through stewardship and informed investment decisions using sound business acumen. In order to meet this goal, DLA:

- Issued Defense Logistics Agency Manual 5025.08, *Pricing Oversight Program*, dated March 6, 2018;
- Issued Enterprise Standard Operating Procedure (eSOP) 5025.08.01, *Independent Government Cost Estimate* in February 2018;
- Continued upgrades to Pricing Tool Master Suite functionality;
- Provided DLA-specific pricing training – scheduled 24 classes during FY2018, set FY2019 target for more than 20 classes; and
- Developed and included a Cost Recovery Rate (CRR) for fuel pricing in the FY 2020 budget submission.

Audit Remediation: DLA will sustain FY2018 audit progress and remediate the high-risk findings for inventory, real property, and information technology general controls in FY2019. DLA's goal is to obtain at least one unmodified financial statement audit opinion for the General, Transaction, or Working Capital Fund by FY2020, while continuing to make progress in all areas. In order to accomplish this, DLA has/will:

- Created a prioritized plan for remediation of FY2018 audit findings.
- Develop Internal Control Program that concentrates work efforts on previous audit findings and continuous testing and validation once a corrective action plan has been implemented.
- Generate internal control test plans for all identified enterprise risks and for one/third of Local Risk Profiles (LRP).

Mitigate Risks: DLA strengthened risk management to ensure secure, agile, and resilient combat logistics support. In order to meet this goal, DLA has:

- Implemented cash management procedures with accurate cash balance reports and performs maintenance of cash within critical limits; and
- Identified and is actively managing the enterprise risk by completing the required quarterly and annual reports.

LOE #6: People and Culture

DLA's goal for FY2018 was to continue to attract and retain highly skilled, mission-focused people, further develop their competencies and resilience, cultivate the next generation of leaders, and foster an environment that unlocks the full potential of our employees in order to meet current and future mission demands. Significant accomplishments for FY2018 were as follows:

Develop Leaders: DLA continued to implement career development and educational initiatives to ensure leaders and candidates for such positions were equipped with the ability to lead an increasingly diverse workforce effectively. In order to meet this goal, DLA has:

- Held monthly enterprise leader discussion forums on key areas (e.g., DLA strategic plan, conflict management, trust in the workplace, leadership philosophies, giving and receiving feedback, generational differences in the workplace, and succession management);
- Launched a pilot certification program for DLA's emerging leaders; and
- Developed a leadership competency model for FY2019 to assess DLA leaders on critical leadership skills, determine gaps, and subsequently develop closure strategies.

DLA also continued to implement its succession management framework to ensure continuity in key positions and mitigate knowledge gaps due to personnel attrition.

Resource the Enterprise: DLA continued to implement an improved hiring assessment approach to yield better-qualified candidates and a more transparent, balanced hiring process.

Manage the Talent: DLA continued to implement competency assessment models and develop career-planning tools to meet current and future mission requirements. DLA will deploy competency models for mission critical occupations (e.g., acquisition, leadership) in FY2019 to identify and close critical competency gaps. Similarly, DLA developed career maps for workforce occupations to enhance workforce professional development. DLA continued to execute an enterprise strategic workforce-planning framework that ensures functional community leaders remain informed of roles, responsibilities, and key issues through bi-annual meetings and periodic health assessments of their functional community's current state.

Fortify the Culture: DLA launched the 2018 Culture and Climate Survey that evaluates organizational effectiveness and climate and affords the Agency the ability to address challenges respectively, thus increasing employee satisfaction and engagement, and promoting shared enterprise values. DLA will develop and implement enterprise and organizational action plans in FY2019 to address challenges identified in survey results.

Perform and Reward: During FY2018, DLA successfully completed the mid-point review, annual ratings, and award processes for our first DoD Performance Management and Appraisal Program (DPMAP) performance cycle that ended on March 31, 2018, as well as the performance planning process for our second cycle than began on April 1. DPMAP established a systematic process for planning, monitoring, evaluating, recognizing, and rewarding employee performance that contributes to mission success. DLA leveraged DPMAP to sustain a high-performance culture that promotes meaningful and ongoing dialogue between employees and supervisors, and holds both accountable for performance.

Protect the Workforce: The critical task in creating a safety culture is to execute a predictive Safety and Occupational Health program. To achieve this objective, DLA is providing MSCs with the capabilities they need to make timely, informed decisions based on risk. In August 2018, DLA published Defense Logistics Agency Instruction (DLAI) 6055.01, *Safety and Occupational Health Program*. The DLAI provides the policy and framework for MSCs and OCONUS Regions to establish their inspection program and use the risk management process as part of their operations.

LOE #7: Enterprise Enablers (Technology, Innovation, and Data Management)

These strategies follow several core tenets: shifting to commercial IT solutions and cloud-based services; promoting the collection and analysis of the right data to facilitate optimum decision-making; and improving processes to enhance our agility.

Transform DLA's IT Strategy (Stakeholder Map): DLA plans to create an innovation-focused stakeholder map that identifies the technology and processes ripe for modernization. Based on the results of this map, DLA will formulate a revised IT strategy. This is a deliberate effort based on "Design Thinking" principles.

DLA collaborated with industry to develop and transition manufacturing and logistics innovations to improve supply chain management, cybersecurity and supply availability, ensuring more reliable, cost effective products and solutions that support the Warfighter.

Transform DLA's IT Strategy (Data Management): The purpose of the data and analytics strategy plan is to define the vision and mission for Enterprise Data and Analytics, outlining a set of activities to achieve and implement that vision. These activities are as follows:

- Data Science Activities (i.e., Predictive/Advanced Analytics): DLA integrated new data streams, data science, advanced analytics, and activities – to include acquiring necessary skillsets, properly aligning analytics resources, and establishing an opportunities framework for the development, collection, and prioritization of analytics use cases.

- Technology Fusion Capabilities: DLA provided technological capabilities to perform data visualizations, integrated analytical capabilities, big data capabilities via an enterprise data lake, and integration of agile development methodologies.

- Content Management Services: DLA is the catalyst for information automation and achieving savings for the entire Department, while directly supporting Audit Readiness and Records Management initiatives.

- Engineering and Technical Data Digitization and Management: DLA identified and executed R&D projects to ensure the industrial base has efficient access to digitized engineering and technical data, including three-dimensional (3D) geometric models.

DLA operates in a mission-driven, capability-based IT environment. The technology must be available, current, and secure to perform our mission. DLA technology must include reliable information available on demand, and interoperable applications easily adaptable and able to integrate to meet emerging mission needs.

DLA uses state of the art technology and maintains a suite of cybersecurity hardware and software that is constantly monitoring and protecting DLA's information assets and people. The cyber threat is real and imminent and can be gravely damaging if not countered. DLA maintains a secure and resilient DLA cyberspace operating environment through the incorporation of security technology and operational best practices, while focusing on reducing the number and severity of existing vulnerabilities.

IT Strategy (Intelligent Automation Strategy): DLA's goal is to develop an Intelligent Automation Strategy to implement digital labor and reduce manual and repetitive workload.

DLA modernized and enhanced the DLA supply chain using automation, analytics, and commercial off-the-shelf supply chain applications. Getting the right item to the right customer expeditiously is dependent on the best technology available.

Financial Management and Results

The following analysis provides an overview of DLA funding mechanisms and the information presented in the financial statements and notes.

DLA Funding Sources

DLA receives funding through the Defense-Wide WCF, General Fund (GF), and Transaction Fund (TF). DLA prepares financial statements and notes for the WCF, GF and TF. The Financial Statements and the Notes in this report relate to the WCF only.

Working Capital Fund

In FY2018, the WCF financed $52.3 billion in operations, making it DLA's primary source of financing for operations. The Agency's budget is 97% resourced through contract authority in which the Agency's operating expenses are funded by revenues from customer purchases. This financing model identifies the cost to procure goods and services enabling the customer to use pricing and delivery information in its decision-making process. This visibility also supports DLA's performance measures that ensure DLA activities operate consistently within budget execution targets, address program requirements, and foster productivity improvements.

Supply Chain Management

The WCF Supply Chain Management (SCM) is DLA's largest business area and accounts for nearly all DLA assets, liabilities, revenues, and costs on its financial statements. It provides customer support through its management of logistical processes. DLA's SCM is comprised of the DLA Material, DLA Energy, DLA Distribution, and DLA Disposition Services supply chains.

- DLA Material supply chains include DLA Aviation, DLA Land and Maritime, and DLA Troop Support. DLA Aviation provides consumable parts and operating supplies for aviation weapons systems. DLA Land and Maritime provides consumable parts and operating supplies for land and sea-based weapon systems. DLA Troop Support includes the following material supply chains: Subsistence, Medical, Clothing and Textiles, Construction and Equipment, and Industrial Hardware.

- DLA Energy provides comprehensive worldwide energy solutions to the DoD and other authorized customers. DLA Energy serves as the DLA's executive agent for the bulk petroleum supply chain. The DLA Energy business includes sales of petroleum and aerospace fuels;

arranging for petroleum and aerospace support services; providing facility/equipment maintenance on fuel infrastructure; performing energy-related environmental assessment and cleanup; coordinating bulk petroleum and aerospace transportation; and performing petroleum quality surveillance functions worldwide. DLA Energy also performs procurement functions for electricity, natural gas, and privatization of utility systems for the Military Services.

- DLA Distribution Services provides a single, unified materiel distribution system for DoD. It receives, stores, and issues materiel worldwide. Distribution Centers also provide refrigerated storage, cylinder refurbishment, tent repair, medical unit assemblies, and kitting including assembly or disassembly.

- DLA Disposition Services supports and coordinates the disposal of excess and surplus property within DoD. Property not reutilized within DoD is available for transfer to other Federal agencies or for donation to authorized non-profit organizations or state and local governments. Property not reused, transferred, or donated is either competitively sold or disposed of in an environmentally safe manner. A critical part of the DLA Disposition Services mission is to arrange for the worldwide disposal of hazardous waste in compliance with laws and regulations.

DLA Information Operations Document Services

DLA Information Operations Document Services provides printing, duplicating, and document automation services within DoD to include document workflow conversion, electronic storage and output, and distribution of hard copy and digital information.

The DLA WCF Statement of Net Cost (SNC) presents the following: Energy, Supply Chain Management, and Document Services. Supply Chain Management includes DLA Material Supply Chains, DLA Distribution Services, and DLA Disposition Services. DLA Information Operations Document Services is presented as Document Services on the SNC.

Leading and Managing the Agency

The DLA Governance structure (Figure 4) determines priorities and the execution of the WCF programs in in all key areas. For example, during the budget formulation phase, the WCF reviews and proposes the annual program budget request to the Enterprise Operations Planning Council (EOPC). All other pertinent information pertaining to the review, approval, and execution of these WCF programs are reported to senior leadership through the bi-weekly Situational Reports (SITREPs).

Leading and Managing the Agency

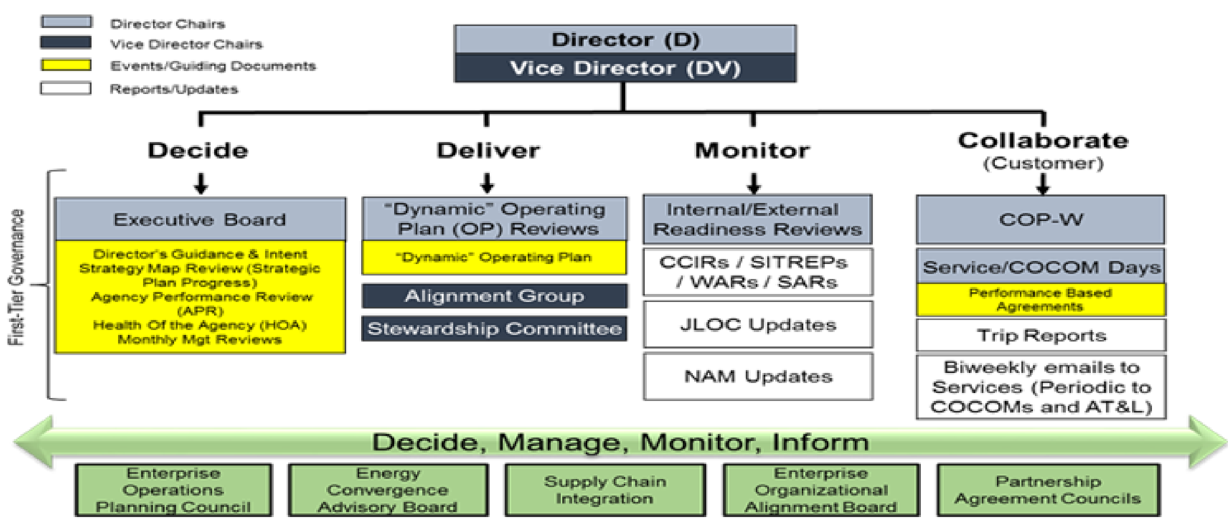


Figure 4, Leading and Managing the Agency

Analysis of Financial Statements and Stewardship Information

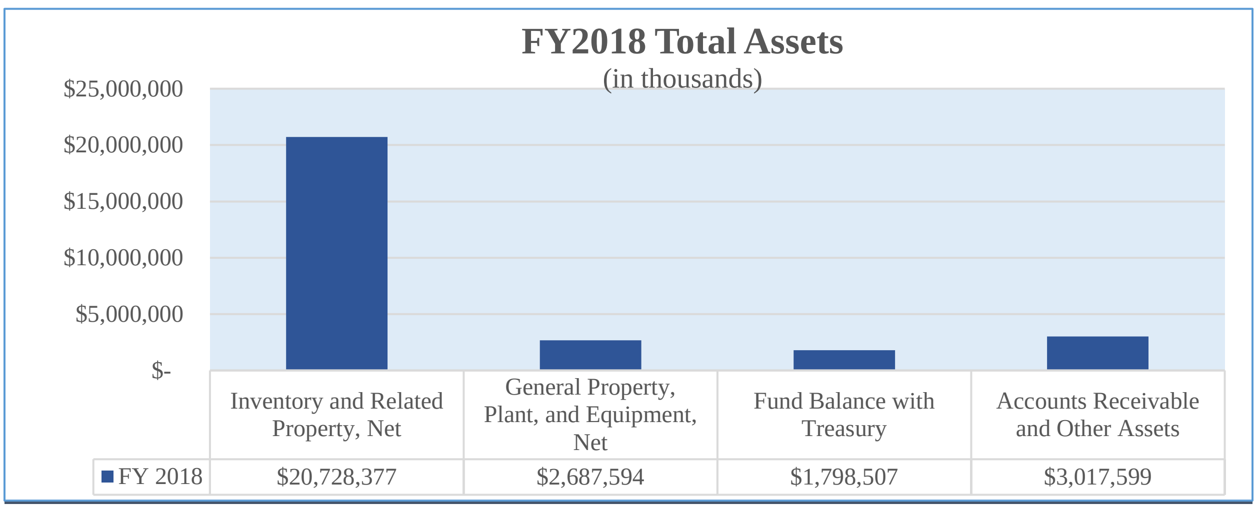
The Financial Statements presented in this AFR relate solely to DLA's WCF. The Financial Statements for GF and TF are located in their respective AFRs. The WCF's budgetary resources were approximately $53.9 billion for FY2018. The DLA prepares its Balance Sheet, SNC, and Statement of Changes in Net Position (SCNP) on an accrual basis; meaning that economic events are recorded as they occur, regardless of when cash is received or disbursed. These financial statements provide the results of our operations and financial position, including long-term commitments and obligations. Budgetary accounting principles require recognition of the obligation of funds according to legal requirements, which in many cases occurs prior to the occurrence of a transaction under the accrual basis. The recognition of budgetary accounting transactions is essential for compliance with legal constraints and controls over the use of Federal funds, and are reported in the Combined Statement of Budgetary Resources (SBR).

DLA evaluates financial results based on the solvency of Defense-Wide WCF (DWWCF) cash position and the ability to meet intended Operating Results of $0 over the long-term and maintain cash balances sufficient to preclude an Anti-Deficiency Act violation.

Balance Sheet

The Balance Sheet presents the resources owned or managed by the DLA that have future economic benefits (assets) and the amounts owed by DLA that will require future payments (liabilities). The difference between the DLA's assets and liabilities is the residual amount retained by DLA (net position) that is available for future programs and capital investments.

Assets – What We Own and Manage



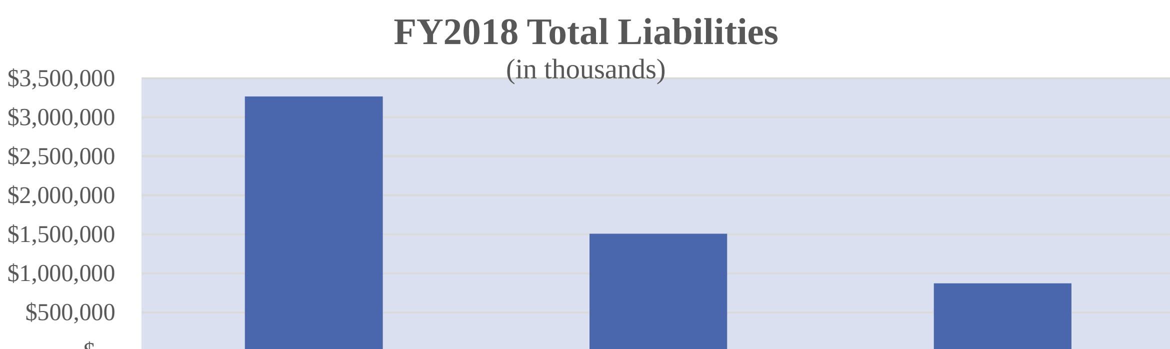
Assets represent amounts owned or managed by the DLA, which are used to accomplish its mission. As of September 30, 2018, the WCF had $28.2 billion in assets.

Inventory and Related Property is the WCF's largest asset and comprises 73.4% of the total assets. Inventory and Related Property balances are primarily comprised of Energy Management and SCM are categorized into inventory held for sale, inventory reserved for future sale, EOU, and inventory held for repair.

General Property, Plant, and Equipment (PP&E), Net is the second largest asset, comprising 9.5% of total assets. The major items in this category include buildings, structures, facilities, software, general equipment and construction-in-progress. These assets provide future benefits to help accomplish the DLA mission. DLA records PP&E assets at cost and depreciates them over the estimated useful lives of the assets. PP&E is presented net of accumulated depreciation.

Other Assets represents 17.1% of total assets, which includes Fund Balance with Treasury (FBwT), Accounts Receivable, and Other Assets.

Liabilities – What We Owe



	Accounts Payable	Environmental and Disposal Liabilities	Other Liabilities
FY 2018	$3,267,767	$1,507,957	$873,298

Liabilities are the amounts owed: to the public or other Federal agencies for goods and services provided but not yet paid; to DLA employees for wages and future benefits; and for other liabilities. As of September 30, 2018, the WCF reported approximately $5.6 billion in total liabilities.

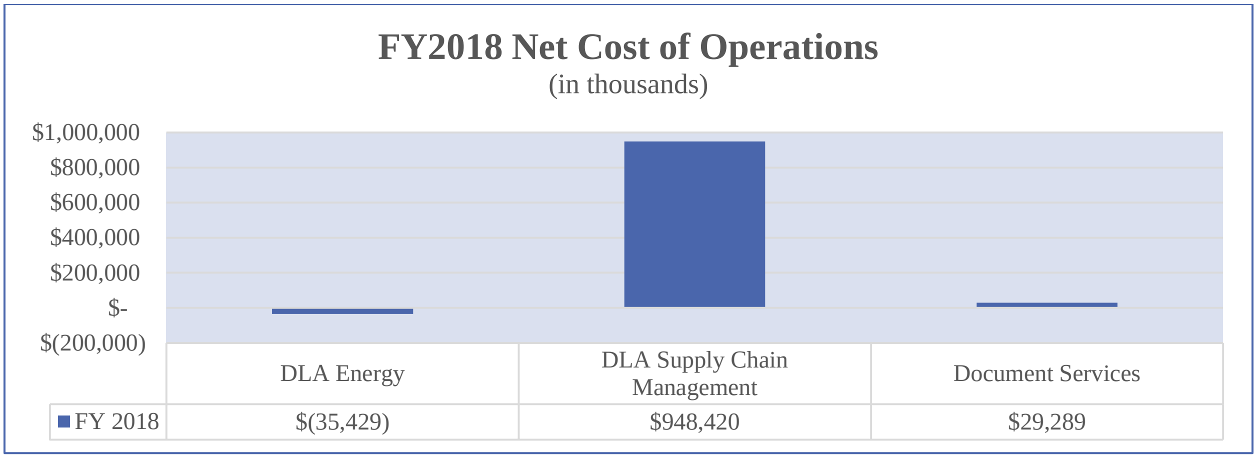
The WCF's largest liability is for *Accounts Payable*, which represents 57.8% of total liabilities and results from amounts owed to other Federal agencies and the public for goods and services received by DLA.

Environmental and Disposal Liabilities represent 26.7% of total liabilities, and is comprised of environmental cleanup costs associated with restoration of environmental sites. These environmental sites may include, but are not limited to, decontamination, decommissioning, site restoration, site monitoring, clean closure of assets, and post-closure costs related to the Agency's operations that result in hazardous waste.

Other Liabilities, comprising 15.5% of the WCF's liabilities, includes amounts due to the Other Federal Employment Benefits and other liabilities.

Statement of Net Cost

Net cost of operations represents the difference between the costs incurred and revenue earned by WCF programs. The DLA WCF SNC is broken into DLA Energy, DLA SCM, and DLA Information Operations Document Services.



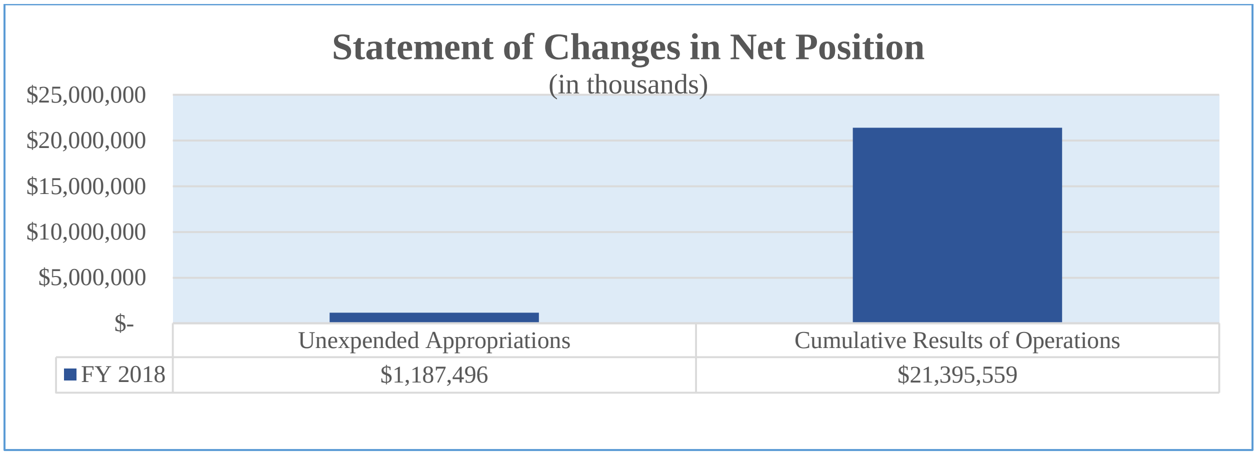
DLA Energy includes operations related to the sale and management of jet fuel, gasoline, heating oil, diesel, naval propulsion fuel, lubricants, and missile propellants. DLA SCM includes operations related to Troop and Weapon Systems Support supply chains. DLA Information Operations Document Services includes operations related to automated document production, printing services, digital conversion, and document storage.

The Statement of Net Cost for Energy operations indicates revenue exceeded expenses, however the events that produced this result were generated by the asset cleanup initiative performed by Energy in FY2018 and other inventory related adjustments resulting in increased gains. Assets were recorded in the Enterprise Business System (EBS) as transfers-in, which were recorded in the gain account. DLA is unable to quantify which assets were proper transfers-in and which ones should not have been recorded as such.

During FY2018, the WCF earned approximately $40.9 billion in exchange revenue. Exchange revenue arises from transactions in which the WCF provides and the other party receives value and that are directly related to WCF operations.

Statement of Changes in Net Position

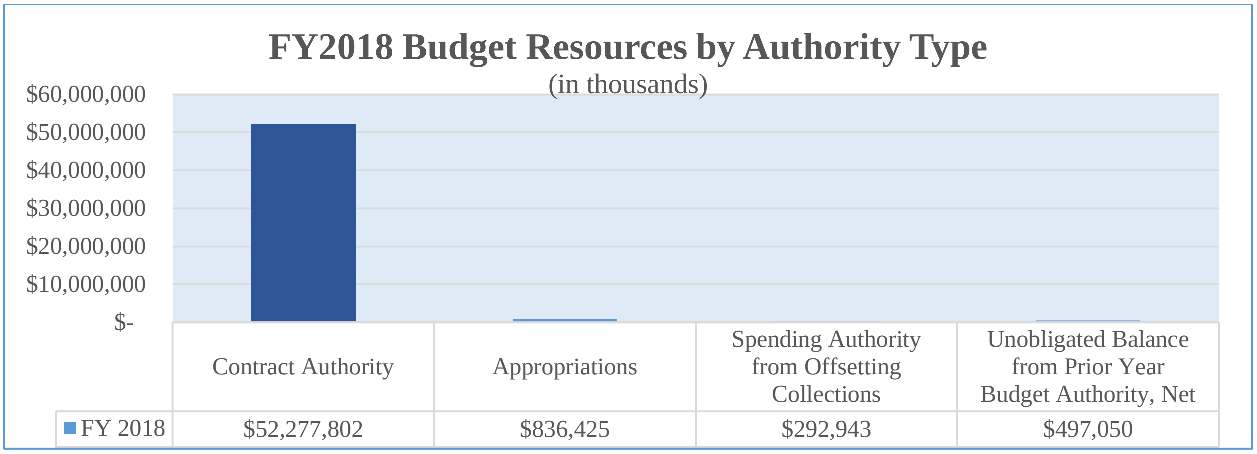
Net position represents the accumulation of revenue, expenses, budgetary, and other financing sources since inception, as represented by WCF's balances for cumulative results of operations on the SCNP. Financing sources increase net position and include, but are not limited to, appropriations. The net costs discussed in the section above as well as transfers to other agencies decrease net position. For FY2018, total net position was $22.6 billion.



Combined Statement of Budgetary Resources

This statement provides information on the status of the approximately $53.9 billion in budgetary resources available to the WCF during FY2018.

The authority was derived from appropriations of $836.4 million, $497.1 million in authority carried forward from FY2017, $52.3 billion in contract authority, and $292.9 million in spending authority from offsetting collections.



As of September 30, 2018, $1.3 billion of the $53.9 billion was not yet obligated. The $1.3 billion represents apportioned funds available for future use. Of the total budget authority available, the WCF incurred a total of $52.6 billion in obligations from salaries and benefits, purchase orders placed, contracts awarded, or similar transactions.

Limitations of Financial Statements

The principal financial statements were prepared to report the financial position and results of operations of WCF, pursuant to the requirements of 31 U.S.C. 3515(b). While the statements were prepared from DLA's books and records in accordance with the formats prescribed by the Office of Management and Budget (OMB), the statements are in addition to the financial reports used to monitor and control budgetary resources.

To the extent possible, the financial statements were prepared in accordance with Federal accounting standards and the formats prescribed by OMB Circular A-136, *Financial Reporting Requirements*. At times, the DLA is unable to implement all elements of the standards due to financial management systems limitations. DLA continues to implement system improvements to address these limitations. The financial statements should be read with the realization that they are for a component of the U.S. Government.

DLA and the Defense Finance and Accounting Service (DFAS) prepared the FY2018 WCF financial statements from available automated finance, accounting, and feeder systems (such as acquisition, logistics, and personnel systems) and manual processes. Due to system deficiencies, there are limitations in collecting the data needed to prepare financial statements that comply with Federal standards. To prepare the financial statements, DFAS made numerous adjustments during the compilation process in an attempt to overcome these deficiencies.

DLA has several corrective actions underway intended to improve the underlying systems, business processes and internal controls.

The DLA WCF is unable to fully prepare the financial statements in conformity with United States Generally Accepted Accounting Principles (U.S. GAAP). This is due to financial and nonfinancial management system limitations, as well as limitations on the underlying processes that support these statements. These systems are designed to maintain accountability over assets, liabilities, and budgetary resources. They are not designed to prepare financial statements in accordance with U.S. GAAP. DLA continues to take actions to bring its financial and nonfinancial systems and processes into compliance with U.S. GAAP and other Federal regulations. DLA continues to implement interim mitigation processes to address known limitations; additionally, DLA is remediating deficiencies to the financial statement preparation process. DLA has identified non-U.S. GAAP accounting practices or policies; therefore, has not presented comparative financial statements as a result of the U.S. GAAP departures.

Analysis of Systems, Controls, and Legal Compliance

DLA management is responsible for establishing, maintaining, and assessing internal controls to provide reasonable assurance that the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 (31 USC 3512, Sections 2 and 4) and the Federal Financial Management Improvement Act (FFMIA) of 1996 (Pub. L. 104-208), as prescribed by GAO Green Book, *Standards for Internal Control in the Federal Government,* are met.

In FY2014, the GAO revised the Green Book effective beginning FY2016 and for the FMFIA reports covering that year. The Green Book provides managers the criteria for an effective internal control system, organized around internal control components, principles, and attributes.

OMB Circular No. A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, as amended, emphasizes the integration of risk management and internal controls within existing business practices across an agency. DLA continues to implement improvements to internal controls to strive for compliance with all applicable laws and regulations.

Management Assurances

The following section provides an overview of DLA's Management's Assurances related to FY2018.

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD
FORT BELVOIR, VIRGINIA 22060-6221

AUG 2 3 2018

MEMORANDUM FOR SECRETARY OF DEFENSE

THROUGH: UNDER SECRETARY OF DEFENSE (ACQUISITION AND SUSTAINMENT)

SUBJECT: Annual Statement of Assurance (SOA) Required Under the Federal Managers' Financial Integrity Act (FMFIA) for Fiscal Year (FY) 2018 Working Capital Fund

As Director, Defense Logistics Agency (DLA), I recognize DLA is responsible for managing risks and maintaining effective internal control to meet the objectives of Sections 2 and 4 of the FMFIA of 1982. DLA conducted its assessment of risk and internal control in accordance with the OMB Circular No. A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control* and the Green Book, GAO-14-704G, Standards for Internal Control in the Federal Government. Based on the results of the assessment (see attachments), DLA is unable to provide assurance that internal controls over operations, reporting, and compliance were operating effectively as of September 30, 2018.

DLA conducted its assessment of the effectiveness of internal controls over operations in accordance with OMB Circular No. A-123, the GAO Green Book, and the FMFIA. The *"Internal Control Evaluation"* section provides specific information on how DLA conducted this assessment. Based on the results of the assessment, DLA is unable to provide assurance that internal controls over operations, reporting, and compliance were operating effectively as of September 30, 2018.

DLA conducted its assessment of the effectiveness of internal controls over reporting (including internal and external financial reporting) in accordance with OMB Circular No. A-123, Appendix A. The *"Internal Control Evaluation"* section provides specific information on how DLA conducted this assessment. Based on the results of the assessment, DLA is unable to provide assurance that internal controls over operations, reporting (including internal and external reporting), and compliance were operating effectively as of September 30, 2018.

DLA also conducted an internal review of the effectiveness of the internal controls over the integrated financial management systems in accordance with Federal Financial Management Improvement Act (FFMIA) of 1996 (Public Law 104-208) and OMB Circular No. A-123, Appendix D. The "*Internal Control Evaluation*" section provides specific information on how DLA conducted this assessment. Based on the results of this assessment, DLA is unable to provide assurance that the internal controls over the financial systems are in compliance with the FFMIA and OMB Circular No. A-123, Appendix D, as of September 30, 2018.

Point of contact is Billie Sue Goff and can be reached at (571) 767-7736 or email: billie.goff@dla.mil.

DARRELL K. WILLIAMS
Lieutenant General, USA
Director

cc:
Office of the Under Secretary of Defense (Comptroller)
Office of the Chief Management Officer

Federal Financial Management Improvement Act

As mandated by FFMIA and OMB Circular A-123 Appendix D, *Compliance with the Federal Financial Management Improvement Act of 1996*, Federal agencies subject to the CFO Act must provide, as part of their annual assurance statement, an assessment of whether the agency has substantially complied with the three FFMIA Section 803(a) requirements.

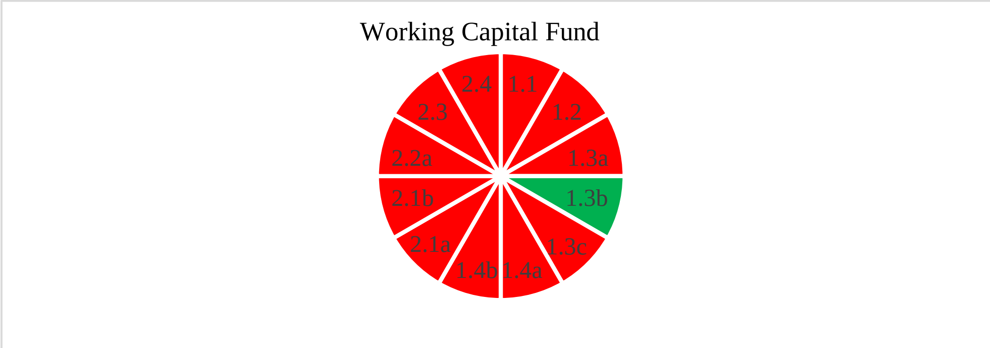
- Federal Financial Management System Requirements (FFMSRs),
- Applicable Federal accounting standards, and
- The U.S. Standard General Ledger (USSGL) at the transaction level.

OMB Circular A-123, Appendix D provides a framework to assist with determining compliance with FFMIA. The FFMIA compliance determination framework includes a series of Federal financial management goals and associated compliance indicators that assist the agency head in determining whether the agency has substantially complied with the requirements of FFMIA.

DLA leveraged the OMB Circular A-123 Appendix D compliance determination framework to perform a review of data for each of the FFMIA compliance indicators and associated analysis in order to determine compliance with FFMIA.

OMB Circular A-123 Appendix D Goals	OMB Circular A-123 Appendix D Compliance Indicator
Goal 1.1: Consistently, completely, and accurately record and account for Federal funds, assets, liabilities, revenues, expenditures, and costs.	1.1.a Current / prior year's agency-reported material weaknesses, reportable conditions, or non-conformances, or auditor-reported material weaknesses, or significant deficiencies relating to this goal
Goal 1.2: Provide timely and reliable Federal financial management information to agency program managers.	1.2.a Current / prior year's agency-reported material weaknesses, reportable conditions, or non-conformances
Goal 1.3: Provide timely and reliable Federal financial management information for use by stakeholders external to the agency.	1.3.a Audit opinion on agency financial statements
	1.3.b Unaudited interim agency financial statements submitted to OMB within 21 calendar days after the end of the first three quarters of the FY
	1.3.c Agency financial reports submitted to OMB, the Government Accountability Office, and the Congress by November 15

OMB Circular A-123 Appendix D Goals	OMB Circular A-123 Appendix D Compliance Indicator
Goal 1.4: Provide timely and reliable Federal financial management information that can be linked to strategic goals and performance information.	1.4.a Agency costs, as presented in the Statement of Net Costs, in accordance with OMB Circular A-136, are clearly linked to agency strategic goals and are free from agency-reported material weaknesses, reportable conditions, or non-conformances, or auditor-reported material weaknesses or significant deficiencies
	1.4.b Financial and performance information, as presented in the performance section of the Agency Financial Report, is free from agency-reported material weaknesses, reportable conditions, or non-conformances
Goal 2.1: Provide internal controls to restrict Federal obligations and outlays to those authorized by law and within the amount available.	2.1.a Current / prior year's agency-reported material weaknesses, reportable conditions, or non-conformances, or auditor-reported material weaknesses or significant deficiencies relating to this goal
	2.1.b Anti-Deficiency Act Violation Report required to be submitted
Goal 2.2: Perform Federal financial management operations effectively within resources available.	2.2.a Current / prior year's instances of non-compliance with laws and regulations related to prompt payments or debts owed to the Federal Government
Goal 2.3: Minimize waste, loss, unauthorized use, or misappropriation of Federal funds, property and other assets within resources available.	2.3.a Current / prior year's agency-reported material weaknesses, reportable conditions, or non-conformances, or auditor-reported material weaknesses or significant deficiencies relating to this goal
Goal 2.4: Minimize Federal financial management security risks to an acceptable level.	2.4.a FISMA or other (for example, National Institute of Standards and Technology-related) significant deficiencies impacting financial management systems in the agency Security Certification and Accreditation of Federal Information Systems



Based on the application of the OMB Circular A-123, Appendix D FFMIA Compliance Determination Framework and associated analysis of relevant FFMIA compliance indicators available at the time of this report, DLA had high risk factors associated with all three FFMIA Section 803(a) requirements. Eleven of the twelve indicators for the WCF were at the high risk level based on the Risk (Or Performance) Level indicated in the OMB Circular A-123 Appendix D FFMIA Compliance Determination Framework.

FFMSRs: Financial reporting objectives did not include timely financial information for reporting on DLA's financial condition as the Agency Financial Reports (AFRs) for FY2016 and FY2017 were not completed by November 15. In addition, material weaknesses over internal controls over financial reporting and non-compliance related to financial system security were identified.

Federal Accounting Standards: DLA is unable to implement all elements of the Federal GAAP standards due to financial management systems limitations.

USSGL at the Transaction Level: DLA has identified a material weakness in budgetary to proprietary relationships as a result of cumulative differences.

During FY2018, DLA initiated a number of activities to increase the accuracy, reliability, and timeliness of the Agency's financial management information. DLA began operationalizing elements of the Data Profiling and Continuous Monitoring Program (DPCMP) in Data Profiling and Continuous Monitoring Efforts and FFMIA Integration and Sustainment Efforts.

To support the implementation of the DPCMP during FY2018, DLA performed a limited evaluation of the EBS system configuration in relation to the Data Input FFMSRs that represent the ability of the system to capture data that will facilitate compliant transaction processing in accordance with applicable accounting standards. The observations resulting from the EBS configuration evaluation will allow DLA to confirm existing issues and identify additional opportunities to improve compliance with the FFMIA requirements through updates to the EBS configuration.

Executing the Agency's program for FFMIA requires identification, coordination, and integration of all the activities that are related to FFMIA. During FY2018, DLA developed a baseline mapping between the FFMIA compliance objectives reflected in the TFM FFMSRs and DLA's business processes and controls as annotated in Process Cycle Memorandums (PCMs) and Standard Operating Procedures (SOPs). The baseline mapping provides the basis for understanding the operational processes that contribute to each FFMIA objective. The baseline mapping facilitates analysis of FFMIA compliance indicators and supports the identification of gaps in processes and controls that may impact FFMIA compliance.

Financial Management Systems

DLA Information Operations is the DLA knowledge broker, providing comprehensive, best practice Information Technology support to the DoD/DLA Logistics Business Community, resulting in dynamic information systems, customer support, efficient and economical computing, data management, electronic business, telecommunication services, key management, and secure voice systems for DoD and DLA. DLA Information Operations endeavors to improve the control posture of systems and processes by testing and correcting deficiencies to ensure that DLA's systems are compliant with Federal system security and accounting requirements.

DLA Information Operations conducts annual internal reviews of the effectiveness of the DLA internal controls over financial systems. DLA is not able to provide assurance that the internal controls over the financial systems as of September 30, 2018 are in compliance with the FFMIA and OMB Circular A-123.

DLA Information Operations continues to review audit findings from the prior and current financial statement audits, develop corrective action plans, and promptly resolve findings. Deficiencies identified are aligned to the appropriate plans issued for the Enterprise controls to ensure they are addressed in a prompt, consistent and coordinated manner. Systems include:

- Employee Activity Guide for Labor Entry (EAGLE)
- Enterprise Business Systems *(*EBS*)*
- Invoice, Receipt Acceptance, and Property Transfer (iRAPT)

Federal Information Security Modernization Act of 2014

Federal Information Security Modernization Act of 2014 (FISMA) provides a framework for ensuring effectiveness of security controls over information resources that support Federal operations and assets, and provides a statutory definition for information security. FISMA requires the head of each agency to "implement policies and procedures to cost-effectively reduce IT security risks to an acceptable level." DLA Information Operations is the accountable entity within DLA to perform FISMA assessments and reporting.

FISMA reporting is conducted on an annual basis and covers all operating environments of DLA's authorized systems and applications, and also requires management to review the compliance of security personnel with their training requirements. The compliance targets of FISMA reviews are tracked and monitored in Cyberscope, an automated tool that is mandated for use across the Federal Government. The CIO monitors and reviews the FISMA results which are then rolled up at the DoD level for reporting purposes.

Anti-Deficiency Act

The *Anti-Deficiency Act* (ADA) Title 31 USC 1341, prohibits Federal employees from obligating funds in excess of an appropriation, or before funds are available, or from accepting voluntary services. As required by the ADA, DLA's WCF notifies all appropriate authorities of any potential ADA violations.

DLA WCF has two ADA violations in different stages of investigation. The OUSD - General Counsel confirmed one violation of the ADA – Berry Amendment. The Berry Amendment restricts DoD purchases of food, clothing, and other named items unless these items have been grown, reprocessed, reused, or produced in the United States. DLA's ADA investigation found that DLA purchased $278,581 of non-compliant boots. The OUSD(C) is responsible for delivering the formal investigation report to the President, Congress, Treasury, and Office of Management and Budget.

For the second case, DLA delivered an ADA formal investigation report to the OUSD(C) for a legal determination of violation. The report names two potential violations of the Berry Amendment, totaling $616 of ball bearings purchases. If confirmed, DLA will complete the formal investigation during FY2019 and provide the report to OUSD(C) for further legal review and processing.

DLA's WCF has funds control policies to monitor and track commitments, expenditures, and obligations to ensure amounts do not exceed available authority, in compliance with the ADA. DLA's WCF is continuously evaluating the existing processes and controls to identify areas of improvement.

Digital Accountability and Transparency Act of 2014

On May 9, 2014, the President signed the Digital Accountability and Transparency Act of 2014 (DATA Act) into law. The DATA Act is the nation's first legislative mandate for data transparency. It requires the Department of the Treasury and the OMB to transform United States Federal spending from disconnected documents into open, standardized data, and to publish that data online. New requirements starting in January and May of 2017 require the financial community to augment the reporting of awards with expenditure data and balances.

The Department of Defense Activity Address Directory (DoDAAD) is an authoritative data source whose primary function is to provide the automatic addressing functions of the DoD supply chain through the Defense Automatic Addressing System (DAAS) worldwide customers' requisition processing and logistics management processes. The primary mission of DLA Transaction Services is to use the DAAS to receive, edit, validate, route, and deliver logistics transactions for the DoD Components and Participating Agencies. While that requirement remains today, its use has evolved far beyond the DoD supply chain. It now serves to enable and facilitate business system transactions for both the DoD and the other departments of the Federal Government. This affords users with a comprehensive capability and resource for the DoDAAD that appeal to the widest user base of the Federal Government, consistent with the DATA Act.

Through data testing and validation, in FY2018, DLA continued to improve data quality and ensure timely and accurate data reporting to meet and comply with the DATA Act requirements.

DLA is continuously updating Process Cycle Memorandums for which system controls are identified and tested. The results are sent to management for review and evaluation. Additionally, DLA initiated a complete review of finance-related data in EBS, as well as data capabilities. This review is to define ownership, roles, and responsibilities for the data owner and applicable governance considerations (i.e. stakeholders, rules, definitions, control mechanism, and accountability measures). Finance data includes: finance interfaces, Intermediate Documents (IDOCs), customer/vendor master, financial hierarchy (Fund, Fund Center, General Ledger Account Code, Commitment Item), and posting logic. The end result of this is to increase the availability, timeliness, accuracy, visibility and usefulness of DLA financial data as well as to insure standards and processes are in place to achieve and sustain audit opinions.

Forward-Looking Information

The following areas present the greatest insights into how the Agency shapes its programs and responds to challenges posed to DLA WCF goals and missions.

An Ever Changing Workforce

DLA is a dynamic organization, and our workforce is our greatest asset. As we look forward, four significant external factors could impact the DLA workforce. DLA must identify and implement strategies to decrease the impact to the DLA workforce.

The changing demographics is the first significant external factor. There are different generations working side-by-side in the DLA workplace and DLA civilians are playing an increasingly critical role in supporting global DoD missions. These changing demographics will require continued assessment of our current DLA Human Resources initiatives and new strategies in areas such as recruitment, training and development, work-life balance, and managing in a geographically dispersed environment.

Our economy is the second external factor that influences the Federal government's ability to recruit top talent and retain its workforce. DLA must continue to define ourselves as an employer of choice within the Federal sector. This will require the reinforcement of connecting with the DLA mission and with the reputation for valuing diversity and inclusion.

Emerging technologies is the third external factor that transforms the way the DLA workforce works, plays and interact with others. It is important to empower the DLA workforce through technology to meet changing mission requirements. It is important for DLA to have innovative Human Capital management strategies to recruit, develop, and sustain the workforce that is technically proficient and agile to adopt emerging technologies.

The work environment is the last significant external factor to impact the DLA workforce. DLA's success as an organization is largely dependent on our ability to achieve a high-performing, results-driven culture and to sustain it in light of changes to demographics, economics, and technology. Each segment of DLA will be impacted and DLA Human Resources must strategically partner with leadership and the DLA workforce to continue the mission of DLA. The use of Change

Management techniques will assist in decreasing the uncertainty associated with changes as well as mitigate resistance to the changes.

External Threats

In response to the President’s call for governmental reform and under the Direction of the Chief Management Officer, the DoD is reviewing, changing, and setting up processes where appropriate to gain efficiencies and maximize savings to reinvest into Service readiness. This is aligned to the strategic objective of Warfighter First. In support of this effort, DLA stood up a central Reform PMO to coordinate with DoD reform teams and integrate reform efforts across the Agency.

In addition, DLA continuously reviews its strategy to meet global mission requirements as prescribed by the DoD. DLA developed a 2018-2026 Strategic Plan to accomplish its mission to provide “effective logistics support to the operating forces of our military services” at the “lowest possible cost to the taxpayer”. The DLA Strategic Plan reaffirms and extends DLA’s commitment to Warfighter readiness and lethality and to self-accountability. The plan describes seven LOEs that DLA leverages to provide global, end-to-end supply chain solutions: Warfighter First, Global Posture, Strong Partnerships, WOG, Always Accountable, People and Culture, and Enterprise Enablers. Each line of effort has specific objectives.

The “Always Accountable” LOE focuses on building trust and confidence in DLA’s supply chain business by practicing cost consciousness and ethical behavior through reliability and transparency. We hold partners and suppliers to the same high standards as ourselves. DLA aims to attain and sustain auditability through process excellence and sound financial stewardship. DLA strives to achieve a control system that will enable it to provide reasonable assurance over operations, reporting, and compliance. We will continue to document, evolve, and test our processes to ensure we address weaknesses and deficiencies identified in this document.

Risk management is foundational to improve mission delivery, reduce costs, and focus corrective actions. Each Federal employee is responsible for safeguarding Federal assets and efficiently delivering services to the public. Strengthening risk management will ensure secure, agile, and resilient combat logistics support. DLA is responsible for implementing management practices that effectively identify, assess, respond, and report on risks. ERM and Internal Control are components of the governance framework.

A culture of risk awareness is steadily maturing. Employees are empowered to use risk assessments proactively to pinpoint issues within their processes. Sufficient risk assessments proactively define, document, and communicate risk before it becomes problematic and adversely affects processes. The DLA Enterprise A-123 Branch created a standardized risk assessment template and offered fourteen training sessions to encourage process owners to conduct quantitative and qualitative risk assessments on their processes. The risk assessment gathered important detail including risk description, unmitigated risk score, mitigation strategy, mitigated risk score, and responsible parties.

DLA faces current and future cyber threats that must be countered in a sustained effort to secure and defend the Agency's critical operational data, network, and business systems by applying key security principles, which include:

- Operations-level Situational Awareness;
- Layered perimeter defenses;
- Least privilege for access to data and IT capabilities; and
- Physical or logical segmentation of networks, services, and applications.

These proactive defensive measures serve to provide assurance to data and mission owners in the confidentiality, integrity, and availability of DLA's networked infrastructure and business system portfolio, thus enabling and informing strategic-level decision-making.

Technological Advancement and Initiatives

DLA Information Operations continuously evaluates our IT operating environment to identify potential opportunities to streamline and automate our processes as well as ensure alignment with DoD and DLA Strategic Initiatives. One example of these types of efforts currently in process include increasing our use of cloud computing technologies and solutions. Many applications have already begun migration to cloud computing.

DLA Finance is working on three major system initiatives: G-Invoice is a Treasury mandated process to improve the reconciliation and coordination of intra-government payments. Second, the implementation of the DoD standard line of accounting will improve interoperability between DoD business systems and provide better end-to-end funds traceability and eliminations reporting to enable successful audits in DoD. Finally, DLA is working to implement SAP's Financial Supply Chain Management module. This module will enhance DLA's reporting and collection of aged accounts receivables to address audit concerns and improve DLA's cash position.

Working Capital Fund is the primary source of financing for DLA operations.

Financial Section (Unaudited)

The Financial Section (Unaudited) demonstrates our commitment to effective stewardship over the funds Defense Logistics Agency receives to carry out its mission, including compliance with relevant financial management legislation. It includes the Working Capital Fund **Financial Statements**: Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Combined Statement of Budgetary Resources, as well as the accompanying **Notes to the Financial Statements**. It also includes the **Independent Auditors' Report** on the Defense Logistic Agency's Working Capital Fund Financial Statements and accompanying Notes, provided by Ernst & Young LLP.

Message from the Chief Financial Officer

NOVEMBER 2018

DLA's Fiscal Year 2018 Agency Financial Report (AFR) offers certain valuable insights into the overall financial operations, accomplishments, and challenges of the DLA, and includes our principal statements of financial accountability to the Department of Defense (DoD). Accountability represents the foundation of stewardship and DLA remains committed to ensuring value, efficiency, and effectiveness in every program. This section of the AFR provides a comprehensive view of DLA's Working Capital Fund (WCF) financial activities.

DLA received a Disclaimer of Opinion on the Agency's WCF financial statements, which means the auditor conducted audit procedures on the statements but was unable to express an opinion on them. Material weaknesses continue to be reported. DLA continues to make strides to correct our material weaknesses, reviewing underlying business processes to provide long-term solutions. The opinion does not overshadow achievements already made, such as interim progress on critical corrective action plan steps, and ongoing audit training provided to all DLA employees.

In the past year, DLA began Financial Transformation and through continued evolution to excellence, this will endure until DLA achieves an unmodified audit opinion. We have taken a holistic, risk-based look at the maturity of our enterprise, and have identified critical focus areas to address audit impediments. These efforts include initiatives to improve the performance of our accounting, financial operations, and customer service to enhance the value of finance to the Agency's mission and values. Key components of Financial Transformation include remediation of Notice of Findings and Recommendations fom financial statement audits, enhancing the reliability of financial statement data, and ensuring the accounting process and related controls document approved policies. For the WCF, we are enhancing our controls over Information Technology General Controls, Inventory, and Real Property.

As I enter my second year as Chief Financial Officer at DLA, I am committed to assisting DLA to reach this goal. We will continue to focus on fixing our critical deficiencies to meet and sustain auditability. Increased confidence in our financial information will ultimately benefit the Warfighter and other key stakeholders. Furthermore, I am going to ensure innovation with the implementation and use of artificial intelligence to reduce manual transactions and to provide enhanced decision-making through building a cost conscious culture in our business. We are confident we have the right team in place to continue our sustained progress toward an unmodified audit opinion, and look forward to working with the DLA community on this shared mission.

Gretchen V Anderson

GRETCHEN V. ANDERSON
Director, DLA Finance
Chief Financial Officer

Introduction

The principal financial statements included in this report are prepared pursuant to the requirements of the Government Management Reform Act of 1994 (Pub. L. 103-356) and the Chief Financial Officers Act of 1990 (Pub. L. 101-576), as amended by the Reports Consolidation Act of 2000 (Pub. L. 106-531), and the DLA Financial Accountability Act of 2004 (Pub. L. 108-330). Other requirements include the OMB Circular No. A-136, as amended, *Financial Reporting Requirements*. The responsibility for the integrity of the financial information included in these statements rests with the management of DLA. Ernst & Young LLP was engaged to perform the audit of the DLA's WCF principal financial statements. The Independent Auditors' Report accompanies the principal financial statements. This report reflects FY2018 information only. As discussed in Note 1, DLA has identified non-U.S. GAAP accounting practices or policies; therefore, has not presented comparative financial statements as a result of the U.S. GAAP departures.

The DLA's WCF principal financial statements consist of the following:

1. The **Balance Sheet** presents those resources owned or managed by the DLA that represent future economic benefits (assets), amounts owed by DLA that will require payments from those resources or future resources (liabilities), and residual amounts retained by DLA comprising the difference (net position) as of September 30, 2018.
2. The **Statement of Net Cost** presents the net cost of DLA operations for the fiscal year ended September 30, 2018. DLA net cost of operations is the gross cost incurred by DLA less any exchange revenue earned from DLA activities and any gains or losses from assumption changes on pensions, other retirement benefits, and other post-employment benefits.
3. The **Statement of Changes in Net Position** presents the change in the DLA's net position resulting from the net cost of DLA operations, budgetary financing sources, and other financing sources for the fiscal year ended September 30, 2018.
4. The **Combined Statement of Budgetary Resources** presents how and in what amounts budgetary resources were made available to the DLA during 2018, the status of these resources at September 30, 2018, the changes in the obligated balance, and outlays of budgetary resources for the fiscal year ended September 30, 2018.
5. The **Notes to the Financial Statements** provide detail and clarification for amounts on the face of the financial statements as of and for the fiscal year ended September 30, 2018.

Financial Statements (Unaudited)

Defense Logistics Agency - Working Capital Fund
Balance Sheet
As of September 30, 2018
(In Thousands)

	Unaudited 2018
ASSETS	
Intragovernmental	
Fund Balance with Treasury (Note 3)	$ 1,798,507
Accounts Receivable (Note 4)	1,637,702
Other Assets (Note 5)	123,306
Total Intragovernmental Assets	**$ 3,559,515**
Accounts Receivable, Net (Note 4)	1,169,378
Inventory and Related Property, Net (Note 6)	20,728,377
General Property, Plant, and Equipment, Net (Note 7)	2,687,594
Other Assets (Note 5)	87,213
TOTAL ASSETS	**$ 28,232,077**
Stewardship Property, Plant, and Equipment (Note 8)	
LIABILITIES	
Intragovernmental	
Accounts Payable	$ 169,731
Other Liabilities (Note 12)	411,243
Total Intragovernmental Liabilities	**$ 580,974**
Accounts Payable	3,098,036
Other Federal Employment Benefits (Note 10)	201,935
Environmental and Disposal Liabilities (Note 11)	1,507,957
Other Liabilities (Note 12)	260,120
TOTAL LIABILITIES	**$ 5,649,022**
Commitments and Contingences (Note 13)	
NET POSITION	
Unexpended Appropriations	1,187,496
Cumulative Results of Operations	21,395,559
TOTAL NET POSITION	**$ 22,583,055**
TOTAL LIABILITIES AND NET POSITION	**$ 28,232,077**

The accompanying notes are an integral part of these statements.

Defense Logistics Agency - Working Capital Fund
Statement of Net Cost
For the Year Ended September 30, 2018
(In Thousands)

	Unaudited 2018
Program Costs	
Energy	
Gross Cost	$ 10,857,648
Less Earned Revenue	(10,893,077)
Net Cost	**(35,429)**
Supply Chain Management	
Gross Cost	30,675,298
Less Earned Revenue	(29,726,878)
Net Cost	**948,420**
Document Services	
Gross Cost	274,087
Less Earned Revenue	(244,798)
Net Cost	**29,289**
Net Cost of Operations	
Total Gross Cost	41,807,033
Less Earned Revenue	(40,864,753)
NET COST OF OPERATIONS	**$ 942,280**

The accompanying notes are an integral part of these statements.

Defense Logistics Agency - Working Capital Fund
Statement of Changes in Net Position
For the Year Ended September 30, 2018
(In Thousands)

	Unaudited 2018
UNEXPENDED APPROPRIATIONS:	
Beginning balances	$ 377,800
Budgetary Financing Sources:	
Appropriations transferred-in/out	836,425
Appropriations used	(26,729)
Total Budgetary Financing Sources	809,696
Total Unexpended Appropriations	1,187,496
Cumulative Results of Operations	
Beginning Balances	21,985,027
Correction of errors	1,344
Beginning Balances, as adjusted	21,986,371
Budgetary Financing Sources	
Appropriations used	26,729
Nonexchange revenue	(10,776)
Transfers-in/out without reimbursement	(650)
Other Financing Sources (Nonexchange)	
Transfers-in/out without reimbursement	154,719
Imputed financing from costs absorbed by others	177,879
Other	3,567
Total Financing Sources	351,468
Net Cost of Operations	942,280
Net Change	(590,812)
Cumulative Results of Operations	21,395,559
Net Position	**$ 22,583,055**

The accompanying notes are an integral part of these statements.

Defense Logistics Agency - Working Capital Fund
Statement of Budgetary Resources
For the Year Ended September 30, 2018
(In Thousands)

	Unaudited 2018
BUDGETARY RESOURCES	
Unobligated Balance From Prior Year Budget Authority, Net	$ 497,050
Appropriations	836,425
Contract Authority	52,277,802
Spending Authority From Offsetting Collections	292,943
TOTAL BUDGETARY RESOURCES	$ 53,904,220
Memorandum (non-add) entries:	
Net Adjustments to unobligated balances brought forward, Oct. 1	$ 13,650
STATUS OF BUDGETARY RESOURCES	
New Obligations and Upward Adjustments (total)	$ 52,587,582
Unobligated Balance, End of Year:	
Apportioned, Unexpired Accounts	1,316,638
Unexpired Unobligated Balance, End of Year	1,316,638
Unobligated Balance, End of Year (total)	1,316,638
TOTAL BUDGETARY RESOURCES	$ 53,904,220
Outlays, net	
Outlays, net (total)	1,113,770
Agency Outlays, net	$ 1,113,770

The accompanying notes are an integral part of these statements.

Notes to the Financial Statements (Unaudited)

Note 1. Summary of Significant Accounting Policies - Unaudited

A. Reporting Entity

Created in 1961, the DLA is a component of the U.S. DoD and reports to the Office of the Under Secretary of Defense (OUSD) for Acquisition and Sustainment through the Assistant Secretary of Defense Sustainment. DLA provides material and services to components of DoD, including the U.S. Army, Navy, and Air Force. The Defense Finance and Accounting Service (DFAS) provides accounting and transaction processing services.

The DLA has the MSCs below to execute the mission to provide supply and logistics service support. These organizations are DLA's revenue generators, manage DLA resources, and are responsible for daily business operations. DLA presents its organizational financial information in a financial statement, subject to U.S. GAAP hierarchy, as defined in Statement of Federal Financial Accounting Standards (SFFAS) 34, The Hierarchy of Generally Accepted Accounting Principles for Federal Entities, Including the Application of Standards Issued by the Financial Accounting Standards Board.

DLA Supply Chain Management (SCM) includes:

- DLA Troop Support (Philadelphia, Pennsylvania) - consists of 5 commodities:
  - Subsistence - food support for the military all over the world.
  - Clothing and Textile - clothing, textiles and equipment to U.S. service members, other Federal agencies and partner nations.
  - Construction and Equipment - construction materials, heavy equipment, tactical gear, firefighting equipment, minerals and precious metals to wood products, imaging and information equipment.
  - Industrial Hardware - industrial items such as screws, nuts, and bolts, typically referred to as bench stock or repair parts.
  - Medical - medical and pharmaceutical supplies.
- DLA Aviation (Richmond, Virginia) - provides repair parts for aviation weapons systems.
- DLA Land and Maritime (Columbus, Ohio) - provides repair parts for ground-based and maritime systems.
- DLA Distribution (New Cumberland, Pennsylvania) - provides storage and distribution solutions, transportation planning, logistics planning and contingency operations as well as, operating a global network of 34 distribution centers.
- DLA Disposition Services (Battle Creek, Michigan) - disposes of excess property by reutilization, transfer and demilitarization; and conducts environmental disposal and reuse.

DLA Energy (Fort Belvoir, Virginia) - provides petroleum products/lubes, Sustainment, Restoration & Modernization, transportation, alternative fuel/renewable energy, aerospace energy, fuel quality/technical support, natural gas and electricity.

DLA Information Operations Document Services (Mechanicsburg, Pennsylvania) – provides automated document production, printing services, digital conversion and document storage.

B. Basis of Presentation

The accompanying financial statements are prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) for Federal entities and presented in the format prescribed by the OMB Circular A-136, Financial Reporting Requirements, except as described in the following paragraphs. The financial statements present the financial position, net cost of operations, changes in net position, and combined budgetary resources of the DLA WCF, as required by the Chief Financial Officers Act of 1990, as amended and the Government Management Reform Act of 1994.

The DLA WCF financial statements have been prepared from the accounting records of DLA WCF, and do not include the DLA General or Transaction funds, which are reported in separate financial statements. Accounting standards require all reporting entities to disclose that accounting standards allow certain presentations and disclosures to be modified, if needed, to present disclosure of classified information.

Interfund transactions and balances among the DLA WCF activities (Energy, Supply Chains and Information Operations Document Services) are eliminated from the Balance Sheet, the Statement of Net Cost, and the Statement of Changes in Net Position. The Combined Statement of Budgetary Resources is presented on a combined basis in accordance with OMB Circular A-136; therefore, interfund transactions have not been eliminated from this statement.

On a DoD agency-wide basis, DLA WCF adjustments are based on the information provided by the seller/service provider unless a waiver is obtained. A waived entity is a DoD reporting entity believed to have complete, accurate, and supported seller or buyer side data. Currently, DLA WCF is a non-waived entity. The elimination adjustments for buyer/seller transactions are based on the buyer's accounts payable and expenses and the seller's accounts receivable and revenue records. DLA WCF is unable to resolve the reconciling differences in amounts reported for the buyer/seller transactions reciprocal category with other defense organizations.

The DLA financial statements are compiled from the underlying financial data of DLA's MSC and Headquarters activities. Some of the financial data at the MSC level may reflect known abnormal balances. However, at the aggregated financial statement level these abnormal balances may not be evident.

DLA WCF is unable to fully prepare financial statements in conformity with U.S. GAAP due to limitations of the financial and nonfinancial management systems and processes that currently support the DLA WCF financial statements. These systems are designed to maintain accountability over assets, liabilities and budgetary resources, rather than preparing financial statements in accordance with U.S. GAAP. DLA has identified non-U.S. GAAP accounting practices or policies; therefore, has not presented comparative financial statements as a result of the U.S. GAAP departures.

DLA is continuing the actions required to bring its financial and nonfinancial systems and processes into compliance with U.S. GAAP. Until all DLA financial feeder systems and processes are able to collect and report financial information as required by U.S. GAAP, DLA continues to implement interim mitigation processes to address these limitations. In addition, DLA is remediating deficiencies found in all end-to-end business process cycles pertaining to reconciliations and adequacy of the supporting documentation identified through audits and other compliance reporting.

Currently, the DLA WCF identified the following non-U.S. GAAP accounting practices or policies that impact DLA's financial statements although others may exist that have not been identified:

- Financial Statements – DLA does not present comparative financial statements due to the identification of non-U.S. GAAP accounting practices or policies.

- Fund Balance with Treasury (FBwT) – DLA is not able to identify its undistributed collections and disbursements because DLA shares a Treasury Index (TI)-97 with Other Defense Organization for Treasury reporting (see Note 1.F).

- Accounts Receivable (Fuel Exchange Agreement (FEA)) - Posting logic issues exist in the FEA business process. The current practice of netting accounts receivable and accounts payable for FEA individual sales and purchase transactions resulted in an overstatement in each of these accounts. A mitigation strategy has been put in place to post a quarterly journal voucher to reverse these transactions until a systemic solution can be implemented. In addition, budgetary entries are not adjusted when the netting of individual sales and purchases transactions occurs. Currently, a journal voucher is processed to adjust the budgetary consumption to correct the budgetary to proprietary variance that occurs when the accounts receivable and accounts payable are adjusted.

- Inventory:
  - EOU Transfer-in – DLA Disposition Services values all EOU transferred from the military services at net realizable value (NRV). In the EBS, the asset is recorded incorrectly as a gain upon receipt rather than a transfer-in.
  - EOU Carrying Amount – DLA is unable to provide the carrying value of EOU inventory.
  - DLA does not properly account for inventory provided to vendors against contracts and work orders for manufacturing and assembly. These items should be initially accounted for as Raw Material, and then as Inventory Work in Process. In addition, DLA does not properly account for additional inventory costs in the manufacturing and assembly process.
  - Customer Direct – In recording Customer Direct transactions, DLA combines the purchase from the vendor and the cost of goods sold into a single entry in EBS that does not include the receipt or issuance of inventory.

- General Property, Plant, and Equipment (PP&E):
  - DLA is unable to determine the valuation of real property and general equipment assets previously transferred from the Military Services.
  - DLA does not have the proper policies and procedures to identify aged Construction in Progress (CIP) balances. DLA will continue to perform an analysis over aged CIP balances in FY2019.

- Leases – DLA does not currently report capital and operating leases in its financial statements (see Note 1.J).

- Accounts Payable – Payment without Receipt (Negative Payable) occurs when a payment is made prior to the goods receipts being posted in EBS. This results in an understatement of current year expenses and payables, and an overstatement of undelivered orders. Monthly, a journal voucher is prepared to properly record the accounting entries.

- Unfilled Customer Orders - The DLA does not have the proper policy and procedures to reconcile the Unfilled Customer Orders from the EBS trial balance to the transaction detail.

- Undelivered Orders - The DLA does not have the proper policy and procedures to reconcile the Undelivered Orders from the EBS trial balance to the transaction detail.

There may be other non-GAAP disclosures in Note 1 of the financial statements that are not disclosed in Note 1.B.

C. Basis of Accounting

U.S. GAAP encompasses accrual transactions. The DLA uses the accrual basis of accounting to prepare the Balance Sheet, Statement of Net Cost and Statement of Changes in Net Position. Under the accrual basis, revenues are recognized when earned and expenses are recognized when liabilities are incurred, without regard to receipt or payment of cash. The Combined Statement of Budgetary Resources is prepared using a budgetary basis of accounting and complies with legal requirements on the use of Federal funding.

The DLA WCF is in the process of establishing the inventory balances using "deemed cost" as defined in SFFAS 48, *"Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials"*. DLA WCF did not make an unreserved assertion in the application of SFFAS 48 (see Note 6).

DLA WCF continues to apply SFFAS 50 "*Establishing Opening Balances for General Property, Plant, and Equipment"* in FY2018 and has not yet made an unreserved assertion in the application of SFFAS 50 (see Note 7).

D. Appropriations and Funding

The DLA WCF received its initial corpus through an appropriation from the Defense Wide Working Capital Fund (DWWCF) and a transfer of resources from existing appropriations or funds. The corpus financed initial operations to obtain goods and services sold to customers on a reimbursable basis to maintain the corpus.

The DWWCF (Treasury Account Symbol (TAS) 97X4930.005)) consists of six activity groups. DLA WCF operates three of the six activity groups which include DLA SCM, DLA Energy, and DLA Document Services. The Defense Finance and Accounting Service (DFAS) and the Defense Information Systems Agency (DISA) operate the other three activity groups. DLA is the cash manager for the DWWCF funding at the .005 level and is responsible for developing DWWCF activity group budget exhibits related to cash and monitoring cash execution. Although DLA shares TAS 97X4930.005 with DFAS and DISA, each agency receives their own separate Annual Operating Budget. The Office of the Under Secretary of Defense (Comptroller) uses a data element referred to as a 'limit' to differentiate the various Other Defense Organizations under TI-97. DLA uses limits assigned to the TI-97 organizations to track spending at a level below the TAS level.

The DLA SCM and Energy receive contract authority for their operating and capital programs. Contract authority is a statutory authority under which contracts or other obligations may be entered into prior to receiving an appropriation, offsetting collection, or receipt for the payment of obligations. Subsequently, the contract authority liquidates through the receipt of customer funds.

The DLA Information Operations Document Services receives spending authority from offsetting collections for its operation program and contract authority for its capital program. Spending authority requires the receipt of customer orders prior to incurring obligations. The spending authority from offsetting collections comes from other Federal agencies which funds reimbursable activities performed by the DLA Information Operations Document Services on their behalf.

E. Non-Entity Assets

Entity assets are assets that DLA has the authority to use in its operations. DLA management has the authority to decide how funds are used or management is legally obligated to use funds to meet entity obligations.

Non-Entity assets are assets that DLA holds on behalf of another Federal agency or a third party and are not available for DLA to use in its normal operations (see Note 2).

F. Fund Balance with Treasury

The DLA WCF does not maintain cash in a commercial bank, but rather in the U.S. Treasury. DLA's share of the .005 TAS balance in the Treasury Account represents the amount available for DLA to pay current liabilities and finance authorized purchases, except as restricted by law. Defense Finance and Accounting Service – Indianapolis (DFAS-IN) uses suspense accounts for its customers, including DLA, to hold transactions temporarily pending clearance for the correct appropriation. The transactions in suspense accounts include unidentified collections, disbursements, Recyclable Materials and Intra-Governmental Payment and Collection Transactions at Month End. All transactions that remain in suspense accounts at month end are reported on the Suspense Account Report to DFAS-IN. The disbursing offices of DFAS, the U.S. Army Corps of Engineers, General Services Administration, and the Department of State's financial service centers process DLA's cash collections, disbursements, and adjustments.

Undistributed disbursements and collections represent the amounts that have been reported to Treasury, but have not yet been posted to DLA's general ledger. Undistributed amounts can be a result of timing, invalid line of accounting, and invalid TAS information.

The DLA adjusts its FBwT account balance to reflect its portion of the U.S. Treasury's Central Accounting and Reporting System (CARS) Account statement, for its Treasury Account Symbols, using the Cash Management Report (CMR).

The CMR is prepared by the Defense Finance and Accounting Service – Indianapolis (DFAS-IN) and provides summary cash position for all Defense Agencies in the Treasury Index (TI-97) by fiscal year and appropriation at limit level.

On a monthly basis, the DFAS-Columbus (CO) uses the CMR to calculate and record adjustments for the undistributed disbursements and collections variance to bring the financial statements in agreement with the U.S. Treasury Cash balance.

Additionally, the CMR is used to populate accounting transaction events in the Departmental 97 Reconciliation and Reporting System (DRRT) which compares transactions recorded between CMR and the accounting system of record, and reports the undistributed disbursement and collection variances.

The DLA is not able to reconcile its FBwT balances in the general ledger directly to the U.S. Treasury balances. DLA policy is to allocate undistributed disbursements and collections between Federal and Non-Federal categories based on the percentage of distributed Federal and Non-Federal accounts payable and accounts receivable. Adjustments for undistributed disbursements and collections are applied to reduce differences of accounts payable and receivable balances between DLA and Treasury's accounts.

G. Accounts Receivable, Net

Accounts receivable represents amounts due to the DLA WCF by other Federal agencies (intragovernmental) and the public (non-Federal). Intragovernmental accounts receivable arise from sales of materials to and services performed for other Federal agencies and are considered fully collectible. There are two main types of sales of materials, DLA Direct sales and Customer Direct sales. DLA Direct sales are from DLA stock to the customer. Customer Direct sales are from the vendor directly to the customer.

Intragovernmental and public receivables consist of sales of petroleum, aerospace fuels and support services from DLA Energy; consumable parts and operating supplies from DLA Aviation and DLA Land and Maritime; various types of materials from DLA Troop Support commodities; storage and distribution services from DLA Distribution; property and environmental disposal from DLA Disposition Services; and Document Services from DLA Information Operations (see Note 1.A for DLA's major revenue generators).

The DLA WCF presents its public accounts receivable net of an allowance for doubtful accounts, which is based on systematic methodology of grouped aged public receivables. DLA evaluates the allowance methodology and estimated allowance percentages quarterly based on historical average collections on aged public accounts receivable. The allowance for doubtful accounts is calculated based on the aged accounts receivable balances from the preceding month, with the exception of FEA accounts receivable, as these are reconciled in periodic settlements with the foreign governments (see Note 1.W for additional information on FEA sales and settlements).

The DLA WCF does not have existing policies and procedures to address the following areas:

- The review of aged intragovernmental receivables, including assessing collectability.

- The assignment of "Dunning" codes in order to accurately maintain a complete population of intra-governmental and non-Federal accounts receivable.

- Validation of accounts receivable and revenue balances associated with manual adjustments.

H. Inventory

The DLA WCF inventory is comprised of SCM and Energy (both areas are reported in EBS) and categorized into:

- Inventory Held for Current Sale - Inventory that is in the process of production for sale or to be consumed in the production of goods for sale or in the provision of services for a fee. In this category, the inventories primarily include petroleum and aerospace products from DLA Energy, weapon system repair parts from DLA Aviation and DLA Land and Maritime, and food and medical supplies from DLA Troop Support. DLA uses the Moving Average Cost (MAC) method to value inventory Held for Sale, Reserved for Future Sale and Held for Repair. The MAC is calculated each time inventory is purchased dividing the total cost of units available by the number of total units available.

- Inventory Held in Reserve for Future Sale - Inventory that is maintained and not readily available in the market or because there is more than a remote chance that they will eventually be needed (although not necessarily in the normal course of operations). Similar to the Inventory Held for Sale, the inventories primarily include weapon system repair parts from DLA Aviation and DLA Land and Maritime, and food and medical supplies from DLA Troop Support. DLA uses the MAC method to value Inventory Held in Reserve for Future Sale.

- EOU Inventory – Excess inventory exceeds management requirements to meet the DLA's mission. Obsolete inventory is no longer useful because of obsolescence. Unserviceable inventory is damaged inventory that is more economical to dispose of than to repair. DLA values EOU inventory at its expected NRV using: 1) a NRV factor based on the methodology identified in DoD FMR 7000.14-R Volume 4, Chapter 4, for materiel turned in to DLA Disposition for disposal, 2) the average sales price per unit sold per material for scrap items, or 3) the fair value rates associated with the inventory condition code as described in DoD FMR 7000.14-R Volume 15, Chapter 7 for items that are held by DLA SCM that have not been turned over to DLA Disposition Services for disposal.

- Inventory Held for Repair - Inventory that is damaged and requires repairs to make it suitable for sale, which includes consumable spares, repair parts and repairable items. Inventory Held for Repair is valued using the allowance method as described in SFFAS 3, Accounting for Inventory and Related Property, and DoD FMR, Volume 4, Chapter 4. Inventory Held for Repair is valued at MAC less an allowance for the estimated repair cost. The allowance is calculated based on 2% of the total value of Inventory Held for Repair.

The DLA WCF does not have proper policies and procedures to address the following areas:

- Appropriate classification and accurate recording of inventory quantities and values in the financial statements.

- Reconciliation of inventory balances between the accountable property system of record and Financial Accounting system.

- Adequate policy, procedure and implementation of methods used to estimate NRV for EOU, allowance for inventory held for repair and review of EOU inventory held at third party.

- Effective design and implementation of inventory count procedures.

- Availability of evidential matter to support underlying transactions.

- Internal controls to ensure transactions are recorded accurately in the proper accounting period and the balances are appropriately reported in the financial statements.

- Internal controls to prevent or detect inappropriate financial gains resulting from transfers of inventory between storage locations from being recorded.

I. General Property, Plant, and Equipment

The DLA WCF General PP&E consists of buildings, CIP, structures, linear structures, internal use software (IUS), IUS under development, and general equipment that are used to facilitate the Agency's mission. The land that these assets reside on is not owned by DLA. DLA uses the straight-line (SL) method to calculate and accumulate depreciation and amortization expenses. The SL method is based on the acquisition cost and depreciated or amortized over the asset's useful life in accordance with SFFAS No 6.

The DLA WCF General PP&E assets are recorded at historical acquisition cost plus improvements when an asset has a useful life of two or more years, and the acquisition cost exceeds the $250,000 capitalization threshold. The PP&E assets acquired prior to October 1, 2013, were capitalized at various thresholds and are carried at the remaining net book value.

The DLA WCF reports Real Property (RP) that DLA derives primary economic benefit from (i.e. defined as 90% or more of the physical capacity of the Real Property to conduct its operations and carry out the programs and mission) and where DLA is responsible for sustainment of the property. OUSD(C) established policy guidelines for financial statement reporting of real property assets: "Real property must be reported by an entity that derives primary economic benefit and is responsible for sustainment of the property." Based on this guidance, the DLA was determined to be the financial reporting organization (FRO) for a large number of general equipment and real property transfers from the military services. Due to insufficient supporting documentation, DLA is not able to confirm whether DLA meets the definition of FRO for those specific assets.

The DLA WCF does not have proper policies and procedures to address the following areas:

- Inaccurate reporting of the aged CIP balance on the financial statements.

- Inconsistent grouping of assets.
- Physical inventory of real property.
- Properly assigned asset classes that drive the useful life or determined quantity and value for real property and general equipment assets.
- Appropriate capitalization of IUS.
- Recording of IUS assets in the appropriate accounting period.

In addition, noted weaknesses in the current accounting system preclude DLA from providing a complete and accurate listing of additions and disposals for real property and general equipment.

J. Leases

In FY2018, DLA continued to assess Agency-Wide business events for the financial recognition of capital and operating leases. In addition, DLA is continuing to assess the implementation requirements of Statement of Federal Financial Accounting Standards (SFFAS) 54, *Leases: An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government and SFFAS 6, Accounting for Property, Plant, and Equipment.*

K. Advances and Prepayments

When advances are permitted by law, legislative action, or presidential authorization, DLA's policy is to record advances or prepayments. As such, payments made in advance of the receipt of goods and services are reported as other assets on the Balance Sheet.

L. Other Assets

Other assets include those assets such as civil service employee pay and travel advances, Strategic Petroleum Reserve and certain contract financing payments not reported elsewhere on the DLA Balance Sheet.

The DLA Energy's Strategic Petroleum Reserve consist of crude oil held by the Department of Energy (DoE) on behalf of the DoD. The DLA has the right to approximately 6.4 million barrels of crude oil held by DoE on behalf of DoD. Public Law 102-396, Section 9149 enacted in November 1992 established the requirement for DoE to acquire and maintain a strategic petroleum reserve for national defense purposes. Section 9149 provided appropriations for the acquisition, storage, and drawdown of such reserve. Proceeds from sales of this reserve will be deposited to DoD's accounts and remain available until expended. The DoE reports this crude oil in inventory in their financial statements, with an offsetting custodial liability to DoD. By law, the reserve cannot be drawn down or released to DoD without a Presidential Order along with the advice from the Secretary of Defense. To date, none of the reserve has been drawn upon, therefore the full inventory remains on hand with DoE.

The DLA SCM conducts business with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor that long-term contracts can cause, DLA may provide financing payments. The Federal Acquisition Regulations, Part 32, defines contract financing payments as, "authorized disbursements to a contractor prior to acceptance of supplies or services by the Government". Contract financing payments clauses are in the contract terms and may include conditions and advance payments, performance-based payments, commercial advances and interim payments, progress payments based on cost, and interim payments under certain cost- reimbursement contracts.

M. Accounts Payable

Accounts Payable includes amounts owed but not yet paid to Federal and non-Federal entities for goods and services received by DLA. DLA WCF estimates and records accruals when services and goods are performed or received (i.e., Mechanization of Contract Administration Services Accrual related to contract financing, Negative Payable Accrual to adjust the timing issues that exist within EBS when an invoice is received and posted without a goods receipt and Outbound Military Interdepartmental Purchase Request Accrual to recognize expenses based on period of performance). DLA also accrues liabilities for transportation services based on the Third Party Payment System, the estimated expenses for purchase cards and feeder systems accrual to capture expenses incurred at month-end but not yet recorded. The accounts payable methodology is a non-U.S. GAAP accounting practice or policy.

N. Commitments and Contingencies

The DLA recognizes contingent liabilities in the DLA's Balance Sheet and Statement of Net Costs when the loss is determined to be probable and the amount can be estimated. In the event of an adverse judgment against the Government, some of the liabilities may be payable from the U.S. Treasury.

DLA WCF does not record an accrual for contingent liabilities if it is not probable and estimable, but does disclose those contingencies that are reasonably possible in Note 13 of the financial statements and considers cases that are unable to be determined to be included in this category. DLA does not disclose or record contingent liabilities where the loss is considered remote.

O. Liabilities

Liabilities represent amounts of monies or other resources likely to be paid by the DLA as a result of a transaction or event that has already occurred. However, liabilities cannot be liquidated without legislation providing resources and legal authority. Liabilities for which an appropriation has not been enacted are, therefore, classified as not covered by budgetary resources (see Note 9).

Unearned revenue received in advance of goods or services that have not been fully rendered are reported as Other Liabilities on the Balance Sheet.

P. Environmental Liabilities

The DLA is responsible for accurate reporting of the environmental expense and liabilities for the real property and/or equipment that it records and reports on its financial statements as assets, regardless of ownership. DLA identifies and estimates accrued Environmental Liabilities (EL) through its annual Cost-to-Complete process. DLA's accrued EL are comprised of environmental cleanup costs associated with restoration of environmental sites on real property that it does not own but has received appropriated funds to execute and manage. These environmental sites may include, but are not limited to, decontamination, decommissioning, site restoration, site monitoring, clean closure of assets, and post-closure costs related to the Agency's operations that result in hazardous waste. Due to noted deficiencies, DLA is not able to reconcile the population of real property assets that encompass the environmental sites closure and asbestos liabilities (see Note 11).

Q. Payroll and Annual Leave Accruals

Accrued payroll consists of salaries, wages, and other compensation earned by employees, but not yet disbursed. The DLA accrues the cost of unused annual leave, including, restored leave, compensatory time, and credit hours as earned and reduces the accrual when leave is taken. The liability is estimated for reporting purposes based on historical pay information.

R. Federal Employee Benefit

The Federal Employees' Compensation Act (FECA), administered by the U.S. Department of Labor (DOL), provides disability and medical benefits to covered Federal employees injured on the job or whose have occupational illness, and the survivor's benefit for employee whose death is attributable to a job-related injury or occupational illness. The DOL bills the DLA annually as claims are paid, and the DLA in turn accrues a liability to recognize the future payments. Payment on these bills is deferred for one year to allow for funding to go through the budget process. In addition, DLA records estimates for the FECA actuarial liability using the DOL's FECA bill.
Similarly, employees that the DLA terminates without cause may receive unemployment compensation benefits under the unemployment insurance program also administered by the DOL, which DOL bills each agency quarterly for paid claims.

S. Pension Benefits

The DLA's civilian employees may participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS), depending on when they started working for the Federal government. Additionally, personnel covered by FERS, also have varying coverage under Social Security. DLA finances only a portion of the civilian pensions. While reporting and funding civilian pensions under CSRS and FERS are the responsibility of the Office of Personnel Management, DLA recognizes an imputed expense for the portion of civilian employee pension's benefit on the Statement of Net Cost. DLA also recognizes corresponding imputed revenue from the civilian employee pension's benefit on the Statement of Changes in Net Position.

T. Revenues

The DLA WCF classifies revenues as either exchange revenue or non-exchange revenue. Exchange revenues arises when DLA provides goods or services to the public or the Federal entities. These revenues are presented on the Statement of Net Cost and serve to offset the costs of these goods and services. DLA WCF activities recognize the revenue from the sale of petroleum products from DLA Energy, weapon system repair parts from DLA Aviation and DLA Land and Maritime, food and medical supplies from DLA Troop Support, or from the reimbursements for good and services provide to DoD activities, other Federal agencies and the public.

DLA Energy Standard Fuel Price

DLA uses a Standard Fuel Price (SFP) per barrel of fuel sold to our customers. DLA is responsible for recommending a SFP to the Office of the Undersecretary of Defense (Comptroller) (OUSD(C)). In the process of determining the recommended SFP, DLA considers the amount necessary to recover the costs of the products and services. Upon receiving DLA's recommended SFP, it is DLA's understanding that the OUSD(C) performs an evaluation of the SFP and determines the final SFP that DLA is required to use for DLA Energy sales.

Customers including the DoD, U.S. Coast Guard, and foreign governments, are charged the SFP. Federal civilian agencies and other authorized customers are charged the cost plus rate, which is the acquisition cost of fuel billed to DLA Energy by the vendor on the day of delivery plus DLA Energy's operational costs incurred.

DLA believes that the policies and procedures used in deriving the recommended SFP to OUSD(C) complies with the U.S. Code Title 10, § 2208 *Working Capital Fund*. However, as the OUSD(C) sets the final SFP, DLA is unable to set the SFP at amounts necessary to recover the full costs of the products and services provided. In FY2018, OUSD(C) provided two rates. From October 1, 2017 to March 31, 2018, the SFP was $90.30 per barrel. From April 1, 2018 to September 30, 2018, the SFP increased to $115.92 per barrel. During the fiscal year ended September 30, 2018, DLA did not recover the full costs of the goods and services provided based on the set SFP. However, the U.S. Code Title 10, § 2208 provides authority for the Agency to recover its costs over time.

Supply Chain Cost Recovery Rate

DLA establishes the selling price of the Supply Chain Management based on a base price and a Cost Recovery Rate (CRR). The base price is primarily the cost of acquiring the goods and services and other material costs (i.e. testing, transportation, etc.). The CRR is percentage added to the base price that allows for DLA to recover the full cost of the goods and services provided, including depreciation of capital assets, in accordance with U.S. Code Title 10, § 2208. For the fiscal year ended September 30, 2018, DLA's policies and procedures in setting the base price and CRR is in compliance with the U.S. Code Title 10, § 2208.

U. Net Position

Net position is the residual difference between assets and liabilities and consists of unexpended appropriations and cumulative results of operations.

Unexpended appropriations represent the amounts of budget authority that are unobligated and have not been rescinded or withdrawn. Unexpended appropriations also represent amounts obligated for which legal liabilities for payments have not been incurred.

Cumulative results of operations represent the net difference between expenses and losses, and financing sources (including appropriations, revenue, and gains), since inception. The cumulative results of operations also include donations and transfers in and out of assets that were not reimbursed.

V. Other Financing Sources

The DLA WCF other financing sources come from congressionally approved appropriation transfers and are recognized as a financing source when used. Other financing sources also include transfers of assets from other government entities, and imputed financing with respect to costs subsidized by other Federal entity for employees' life insurance and pension benefits.

DLA recognizes the costs incurred by the DLA but financed by other entities on behalf of the DLA as imputed financing. DLA WCF recognizes the following imputed costs: (1) employee pension, post-retirement health, and life insurance benefits; (2) post-employment benefits for terminated and inactive employees to include workers compensation under the Federal Employees' Compensation Act; and (3) losses in litigation proceedings.

W. Transactions with Foreign Governments and International Organizations

The DLA sells defense articles and services to foreign governments and international organizations under the provisions of the Arms Export Control Act of 1976. The DLA's fuel transactions with foreign governments are made under the Arms Export Control Act of 1976 program, via direct sales and under the FEA program. The FEAs are international acquisition and cross-servicing agreements established between DLA and the military departments of other nations. DLA utilizes FEAs to account for fuel provided by foreign militaries to the U.S. Military as well as fuel provided by DLA to other nations.

The FEA sale transactions settle on a periodic basis as prescribed in the FEA. Upon settlement with the foreign country, the purchases of fuel from foreign governments (FG) net against sales to the FG. Settlement can be made either in fuel or cash. For cash settlements, the agreements typically call for reciprocal pricing (i.e., prices cannot be more than the participants charge their military service components).

X. Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. These estimates and assumptions include, but are not limited to, contingent liabilities, judgment fund, environmental liabilities, allowance for doubtful account and allowance for inventory held for repair at the date of the financial statements. The actual result from the reported amounts and expenses during the reporting period may differ from these estimates.

Note 2. Non-Entity Assets - Unaudited

Non-Entity Assets as of September 30, 2018, consists of the following (in thousands):

		2018
Non-Federal Assets		
Accounts Receivable	$	2,752
Total Non-Federal Assets	$	2,752
Total Non-Entity Assets	$	2,752
Total Entity Assets	$	28,229,325
Total Assets	$	28,232,077

As of September 30, 2018, DLA has $2.8 million in Non-Entity assets due to Interest, Administrative Fees, and Penalties and Fines Receivables.

Non-Entity assets are assets that DLA holds on behalf of another Federal agency or a third party and are not available for DLA to use in its normal operations.

Note 3. Fund Balance with Treasury - Unaudited

Fund Balance with Treasury as of September 30, 2018, consists of the following (in thousands):

		2018
Status of Fund Balance with Treasury		
Unobligated Balance		
Available	$	1,316,638
Obligated Balance not yet Disbursed		481,869
Total	$	1,798,507

The Status of Fund Balance with Treasury reflects the budgetary resources to support FBwT. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

Unobligated Balance - available represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations and can be used for future obligations.

Unobligated Balance - unavailable represents the cumulative amount of budgetary authority that cannot be used to cover outstanding obligations. As of September 30, 2018, DLA WCF does not have unobligated – unavailable FBwT.

Obligated Balance not yet Disbursed represents funds obligated for goods and services not received, and those received but not paid. The balances also includes budgetary resources accounts such as contract authority and unfilled customer orders.

Non-budgetary FBwT consists of FBwT in unavailable receipt accounts and clearing accounts that do not have budget authority and non-budgetary FBwT such as non-fiduciary deposit funds. As of September 30, 2018, DLA does not have a balance for non-budgetary FBwT.

Note 4. Accounts Receivable, Net - Unaudited

Accounts Receivable, Net as of September 30, 2018, consists of the following (in thousands):

	2018		
	Accounts Receivable	(Less Allowance for Public Doubtful Accounts)	Accounts Receivable, Net
Intragovernmental			
DLA Supply Chain Management	$ 1,316,063	$ -	$ 1,316,063
DLA Energy	294,584	-	294,584
DLA Document Services	27,055	-	27,055
Total Intragovernmental	$ 1,637,702	$ -	$ 1,637,702
Public			
DLA Supply Chain Management	$ 973,411	$ 338,444	$ 634,967
DLA Energy	563,933	29,761	534,172
DLA Document Services	239	-	239
Total Public	$ 1,537,583	$ 368,205	$ 1,169,378
Total	$ 3,175,285	$ 368,205	$ 2,807,080

As of September 30, 2018, the total Accounts Receivable, Net of $2.8 billion consists of gross accounts receivable of $3.2 billion and the allowance for doubtful accounts of $368.2 million.

See Note 1.G. for methodology used to estimate the allowance for public doubtful accounts.

Per OMB Circular No. A-136, *Financial Reporting Requirements*, FY2018 criminal restitutions included in accounts receivable must be disclosed separately. Criminal restitutions recognized in FY2018 represent public accounts receivable, net of $59.3 million. The gross amount of public accounts receivable related to FY2018 criminal restitutions is $62.6 million with an allowance for doubtful accounts of $3.3 million, calculated in accordance with methodology discussed in Note 1.G.

Note 5. Other Assets - Unaudited

Other Assets as of September 30, 2018, consists of the following (in thousands):

		2018
Intragovernmental Other Assets		
Other Assets	$	123,306
Total Intragovernmental Other Assets		123,306
Non-Federal Other Assets		
Outstanding Contract Financing Payments		87,171
Advances and Prepayments		42
Total Non-Federal Other Assets		87,213
Total Other Assets	$	210,519

Other Information:

Intragovernmental Other Assets in the amount of $123.3 million is related to Strategic Petroleum Reserve for national defense purposes. This consists of crude oil held by the Department of Energy on behalf of the DoD.

The DLA SCM conducts business with commercial contractors under two primary types of contracts: fixed price and cost reimbursable. To alleviate the potential financial burden on the contractor that long-term contracts can cause, DLA may provide financing payments. The Federal Acquisition Regulations, Part 32, defines contract financing payments as, "authorized disbursements to a contractor prior to acceptance of supplies or services by the Government." Contract financing payments clauses are in the contract terms and conditions and may include advance payments, performance-based payments, commercial advances and interim payments, progress payments based on cost, and interim payments under certain cost-reimbursement contracts.

Outstanding Contract Financing Payments primarily includes $78.8 million in advance payments to contractors and suppliers and $8.4 million contracting financing payments related to contingent liabilities.

Note 6. Inventory and Related Property, Net - Unaudited

Inventory and Related Property, Net as of September 30, 2018, consists of the following (in thousands):

	2018	Valuation Method
Inventory Categories		
Held for Sale	$ 19,988,049	MAC
Reserve for Future Sale	282,797	MAC
Held for Repair	93,173	MAC
Excess, Obsolete, and Unserviceable	366,221	NRV
Less Allowance for Losses	(1,863)	
Total	$ 20,728,377	

NRV = Net Realizable Value
MAC = Moving Average Cost

Other Information:

Excess, Obsolete, and Unserviceable inventory is valued at its expected net realizable value (NRV). NRV factor is calculated using revenues and cost avoidance to DoD of reutilized and sold materials against the expenses incurred to manage EOU inventory. NRV inventory adjustments are recognized as a loss or gain. DLA is unable to calculate the carrying value for all EOU inventory.

For FY2018, DLA SCM is carrying $129.7 million of inventory not available for sale due to litigation.

DLA recorded adjustments to the inventory balance, which resulted in corresponding gains and losses, which are included in revenue and gross costs, respectively, in the SNC.

Note 7. General Property, Plant, and Equipment, Net - Unaudited

General Property, Plant, and Equipment as of September 30, 2018, consists of the following (in thousands):

	2018				
	Depreciation/ Amortization Method	**Service Life**	**Acquisition Value**	**Accumulated Depreciation/ Amortization**	**Net Book Value**
Major Asset Classes					
Buildings, Structures, and Facil.	S/L	20 or 40	$ 6,450,536	$ (4,348,353)	$ 2,102,183
Software	S/L	2-5 or 10	712,651	(542,318)	170,333
General Equipment	S/L	5 or 10	662,363	(519,705)	142,658
Construction-in-Progress	N/A	N/A	272,420	-	272,420
Total General PP&E			$ 8,097,970	$ (5,410,376)	$ 2,687,594

S/L= Straight Line N/A = Not Applicable

DLA continues to refine its PP&E process by verifying the existence and completeness; confirming rights and obligations by validating documentation from the Military Services to ensure DLA is the appropriate Financial Reporting Organization; and documenting processes through reviewing and updating policy guidance to define the procedures used for the valuation method. DLA has not yet finalized the inventory process for their PP&E. Accordingly, DLA has not made an unreserved assertion that the opening balances of PP&E for FY2018 are presented fairly in accordance with U.S. GAAP.

The DLA WCF determines the useful life of its PP&E using the asset classification and the type of assets (i.e. building, structure, linear structure, improvement, etc.) based on DoD guidance.

DLA recorded additional adjustments to the PP&E balance which resulted in corresponding gains and losses, which are included in revenue and gross costs, respectively, in the SNC.

Note 8. Stewardship Property, Plant, and Equipment - Unaudited

Stewardship General Property, Plant, and Equipment as of September 30, 2018, consisted of the following:

Stewardship Property, Plant, and Equipment (PP&E) are assets with properties that resemble those of the General PP&E that are traditionally capitalized in the financial statements. Due to the nature of these assets, however, valuation is difficult and matching costs with specific periods is not meaningful. Stewardship PP&E includes heritage assets. Heritage assets are items of historical, natural, cultural, educational, or artistic significance, (e.g., aesthetic) or items with significant architectural characteristics. Heritage assets are expected to be preserved indefinitely. In the case where a heritage asset serves both a heritage function and general government operations, the asset is considered a multi-use heritage asset. Multi-use heritage assets are recognized and presented with general PP&E in the financial statements.

The DLA heritage assets have no impact on DLA’s ability to complete its ongoing mission. The DLA's policy is to preserve and account for its heritage assets. There are no restrictions on the use or convertibility of General PP&E except for heritage assets. The DLA's heritage assets consist of one building, one cemetery, two feeding stations and a pasture (land). The DLA's heritage assets are resources that are managed to provide multiple use activities for the public benefit to include compliance with required Federal laws, executive orders, DoD, governing standards and other binding agreements.

The DLA heritage assets at Richmond are components of the original Bellwood plantation which was sold to the Department of the Army in 1941 when the Installation was first created. Bellwood sits on a 23-acre parcel of land in the southeast corner of the larger 611-acre Defense Supply Center Richmond, a secure military facility located at 8000 Jefferson Davis Highway. The house was rehabilitated for use as the Officers’ Club and became the social center of the Installation. The Bellwood house currently serves as a meeting hall and banquet space. The property also contains the Gregory Family cemetery, the historic elk pasture created by James Bellwood, and two feeding stations for the elk. Bellwood was originally listed in the Virginia Landmarks Register in 1973 and in the National Register of Historic Places in 1978. This updated nomination expands the boundaries to include the entirety of the elk pasture.

Note 9. Liabilities not Covered by Budgetary Resources - Unaudited

Liabilities not Covered by Budgetary Resources as of September 30, 2018, consists of the following (in thousands):

		2018
Intragovernmental Liabilities		
Other	$	17,620
Total Intragovernmental Liabilities	$	17,620
Non-Federal Liabilities		
Other Federal Employment Benefits	$	201,935
Environmental and Disposal Liabilities		1,493,749
Other		927
Total Non-Federal Liabilities	$	1,696,611
Total Liabilities Not Covered by Budgetary Resources	$	1,714,231
Total Liabilities Covered by Budgetary Resources	$	3,934,791
Total Liabilities	$	5,649,022

The note above includes the following categories of liabilities:

Intragovernmental Liabilities-Other consists of accruals for current year FECA liability based on DOL records.

DLA WCF also has Non-Federal Liabilities-Other. This category generally consists of contingent legal liabilities.

As of September 30, 2018, DLA WCF does not have any material balances related to Liabilities Not Requiring Budgetary Resources.

Note 10. Other Federal Employment Benefits - Unaudited

Other Federal Employment Benefits as of September 30, 2018, consists of the following (in thousands):

	2018		
	Liabilities	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Other Benefits			
Federal Employees' Compensation Act	$ 201,935	$ -	$ 201,935
Total Other Benefits	$ 201,935	$ -	$ 201,935
Total Other Federal Employment Benefits:	$ 201,935	$ -	$ 201,935

Actuarial Calculations

The DLA actuarial liability for workers' compensation benefits is developed by the Department of Labor's (DOL) Office of Workers' Compensation Programs (OWCP) and provided to DLA at the end of each fiscal year. The liability includes the expected liability for death, disability, medical and miscellaneous costs for approved compensation cases. The liability is determined using a method that utilizes historical benefit payment patterns to predict the ultimate payments. The projected annual benefit payments are then discounted to the present value using the Office of Management and Budget's (OMB) economic assumptions for 10-year U.S. Treasury notes and bonds. Cost of living adjustments (COLAs) and medical inflation factors are also applied to the calculation of projected future benefits.

Actuarial Cost Method and Assumptions

The liability for future workers' compensation benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using OMB's economic assumptions for 10-year U.S. Treasury notes and bonds. Interest rate assumptions utilized for discounting are as follows:

Year 1: 2.72% and thereafter (wage benefits)
Year 1: 2.38% and thereafter (medical benefits)

To provide more specifically for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors (COLAs) and medical inflation factors (Consumer Price Index Medical (CPIMs)) were applied to the calculation of projected future benefits. The actual rates for these factors for the charge back year (CBY) 2018 were also used to adjust the methodology's historical payments to current year constant dollars. The compensation COLAs and CPIMs used in the projections for various CBY were as follows:

CBY	COLA	CPIM
2019	1.31%	3.21%
2020	1.51%	3.48%
2021	1.89%	3.68%
2022	2.16%	3.71%
2023 & thereafter	2.21%	4.09%

To assess the reliability of the model, an analysis was performed by agency to compare projected payments in the last year to the actual amounts. In addition, changes in the liability between the prior year and current year analyses were examined. Based on the analysis, the model and projected actual payments have been stable.

The cost model used for the estimated actuarial liability is updated only at the end of each fiscal year.

Note 11. Environmental and Disposal Liabilities - Unaudited

Environmental Liabilities as of September 30, 2018, consists of the following (in thousands):

	2018
Environmental Liabilities--Non-Federal	
Other Accrued Environmental Liabilities—Non-BRAC	
Environmental Corrective Action	$ 350,888
Environmental Closure Requirements	1,079,772
Asbestos	77,297
Total Environmental Liabilities	$ 1,507,957

The DLA's Environmental and Disposal Liabilities (EL) are comprised of two primary elements: (1) existing obligations supporting the Defense Working Capital Fund environmental restoration programs, and (2) anticipated future costs necessary to complete the environmental restoration requirements at DLA’s Energy and Non-Energy environmental sites.

In FY2018, DLA utilized Version 11.4 of the Remedial Action Cost Engineering and Requirements (RACER) software to generate the FY2019 Cost to Complete (CTC) estimates of anticipated future costs. Cost estimates related to environmental sites under DLA Energy management were generated for 7,244 sites; 72 sites associated with corrective action costs, 4,207 sites associated with closure costs, and 2,965 sites associated with asbestos clean-up costs. Cost estimates related to environmental sites under Non-Energy management were generated for 1,906 sites; one site associated with corrective action costs, 117 sites associates with closure costs, and 1,788 sites associated with asbestos clean-up costs.

Applicable Laws and Regulations for Cleanup Requirements
The DLA is required to clean up contamination resulting from past waste disposal practices, leaks, spills and other prior activities, which may have created a public health or environmental risk. DLA is required to comply with the following laws and regulations where applicable: The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA); the Superfund Amendments and Reauthorization Act (SARA); the Resource Conservation and Recovery Act (RCRA); the Clean Water Act; and other applicable Federal, State, and local laws and regulations. Required cleanup may at times extend beyond Installation boundaries onto privately owned property or onto sites where DLA is named as a potentially responsible party by a regulatory agency. DLA is required to report EL associated with asbestos cleanup in accordance with Federal Accounting Standards Advisory Board (FASAB) Technical Release 10: Implementation Guidance on Asbestos Cleanup Costs Associated with Facilities and Installed Equipment, and FASAB Federal Financial Accounting and Auditing Technical Release No. 2 Determining Probable and Reasonable Estimable for Environmental Liabilities in the Federal Government. Additionally, DLA is required to report EL associated with Non-Military Equipment, commonly known as General Equipment (GE), in accordance with FASAB Technical Release 11 Implementation Guidance on Cleanup Costs Associated with Equipment and follow applicable DLA policy and guidance related to GE. DLA does not currently report EL associated with Non-Military Equipment and is evaluating its EBS GE inventory and working on developing an auditable methodology for estimating the future cost of these EL.

Types of Environmental Liabilities and Disposal Liabilities
The DLA is responsible for the recognition, measurement, reporting, and disclosure of EL not eligible for funding under the Defense Environmental Restoration Program (DERP), also known as Non-Base Realignment and Closure (Non-BRAC) EL. Non-BRAC EL are specifically related to past and current installation activities and operations, and closure and disposal of facilities and equipment. All clean-up is done in coordination with regulatory agencies, other responsible parties, and current property owners. Types of Other Accrued EL - Non-BRAC include:

Environmental Corrective Action - EL associated with the cleanup sites not eligible for DERP funding, typically conducted under RCRA or other Federal or state statutes and regulations.

Environmental Closure Requirements - EL associated with the future closure/decommissioning of facilities on an installation that have environmental closure requirements to include fuel storage tanks and pipelines.

Asbestos – EL associated with the removal, containment, and/or disposal of friable (immediate health threat) and non-friable (not an immediate health threat): (1) asbestos-containing materials from property, or (2) material and/or property that consists of asbestos-containing material at permanent or temporary closure or shutdown of associated PP&E on Non-BRAC installations.

Non-Military Equipment – EL resulting from the disposal of non-military equipment on Non-BRAC installations. Non-Military equipment is equipment that is not intended to carry out battlefield missions. EL cost estimates associated with disposal include, on a current cost basis, the anticipated level of effort required to comply with environmental Federal, state, and/or local statute, regulation, or other legal agreement specific to the equipment decommissioning and/or disposal. DLA does not currently report Non-Military Equipment EL. DLA is evaluating its GE inventory and working on developing an auditable methodology for estimating the future cost of these EL.

Methods for Assigning Estimated Total Cleanup Costs to Current Operating Periods
The DLA uses the RACER software, an independently validated software application, to estimate future environmental costs. The RACER Steering Committee ensures that the software is Validated, Verified, and Accredited (VV&A) in accordance with DoD Instruction 5000.61. Additionally, DLA utilizes historical user-defined costs to estimate future environmental costs.

Nature of Estimates and the Disclosure of Information Regarding Possible Changes Due to Inflation, Deflation, Technology, or Applicable Laws and Regulations
The change in estimate from the prior year CTC can be attributed to the increase in Non BRAC-Corrective Actions due to the inclusion of new known and estimable out-year requirements for Red Hill Tank #5 Release and Edwards Air Force Base Site 31, as well as additional out-year requirements for Point Loma Fuel Farm and DFSP Ozol. These increases were partially offset by a decrease in Non-BRAC Environmental Closure Requirements resulting from reductions in the EBS inventories of tanks and pipelines. Year-to-year fluctuations in DLA's EL are expected due to changes in agreements with regulatory agencies, deflation, inflation, and technology. The latest available version of RACER (Version 11.4) was used to prepare the estimates which reflects a FY17 cost basis since no RACER version was released in FY2018. As a result, an inflation factor was applied to escalate estimates from an FY2017 to FY2018 cost basis.

Uncertainty Regarding the Accounting Estimates used to Calculate the Reported Environmental Liabilities
The cost estimates produced through the CTC process are considered accounting estimates, which require certain judgments and assumptions that are reasonable based upon information available at the time the estimates are calculated. The actual results may materially vary from the accounting estimates if agreements with regulatory agencies require remediation or closure activities to a different degree than anticipated when calculating the estimates. Liabilities can be further affected if investigation of the environmental sites reveals contamination levels that differ from the estimate parameters.

The DLA has instituted extensive controls to ensure that these estimates are accurate and reproducible. Due to the inherent uncertainty involved with environmental contamination and associated remedial actions, RACER, as a parametric cost estimating tool, is used as a preliminary order of magnitude estimate. The stated total liability includes prior year obligations and the estimate of future costs necessary to complete the environmental restoration requirements.

In FY2018, DLA conducted the CTC Roll Forward process bridging the timing gap between the approval and completion of the CTC estimates and September 30, 2018, to determine if any material changes to the CTC estimates occurred during that timeframe. Based on the results of the CTC Roll Forward process, it was determined that material changes to DLA DWCF EL between the time the original CTC estimates were approved and finalized and September 30, 2018 had occurred. Relevant changes are included in the EL balances as stated above on the E&DL footnote and are summarized in the table below:

DWCF Roll Forward Adjustments (in thousands)			
Fund & Program	**Category**	**Material Change**	**Cost Change**
DWCF - Non-BRAC Environmental Closure Requirements	Changes to Asset Inventories	Changes to the DLA EBS POL Storage Tanks and Pipelines inventories resulted in a material decrease to the CTC estimate and EL balance.	$ (99,124)
DWCF - Non-BRAC Asbestos	Changes to Asset Inventories	Changes to the DLA EBS buildings and structures inventory resulted in a material decrease to the CTC estimate and EL balance.	$ (1,944)

*Roll Forward Adjustments are reflected in EL balances stated above on the Environmental and Disposal Liabilities Footnote.

The CTC Roll Forward process is conducted in accordance with the DLA EL CTC Standard Operating Procedure (SOP), the DoD 7000.14-R Financial Management Regulation (FMR) Volume 4, Chapter 13– Environmental and Disposal Liabilities (April 2018) and the OSD memorandum for Strategy for Environmental & Disposal Liabilities Audit Readiness (September 30, 2015).

Additionally, in FY2018, DLA conducted the EL Site Identification (ID) process that reviews an Environmental Event Repository used to track spills and releases at DLA locations and evaluates each event for Out-Year EL potentiality for use in the annual CTC and EL financial reporting. During the FY2018 Site ID Process, environmental events and GE assets were identified as Potential Out-Year ELs due to the lack of sufficient information/data or pending additional corrective or closure actions. These sites will be re-evaluated during the next Site ID process to determine if any changes have taken place and sufficient information/data is available to create an estimate of future costs that would be included in the DWCF EL balance.

Unrecognized Costs

The DLA systematically recognizes Asbestos and Closure liabilities over the useful life of General Property, Plant, and Equipment (PP&E) assets in accordance with DoD FMR Volume 4, Chapter 13, paragraph 130203 (April 2018). The total recognized Asbestos EL balance is stated above in the footnote and the unrecognized Asbestos liability is $16,159 (in thousands). The total recognized Closure liability is stated above in the footnote and the unrecognized Closure liability is $55,386 (in thousands). These liabilities are amortized based on the useful life of the assets as determined in DoD FMR Volume 4, Chapter 6 - Property, Plant, and Equipment, paragraph 060205.J. Table 6-1 (June 2009) DoD Recovery Periods for Depreciable General PP&E Assets.

Cleanup Costs Associated with Asbestos Environmental Liabilities
The DLA's total recognized EL for asbestos related cleanup reported above is $77,297 (in thousands).

Cost estimates were generated for each applicable asset by applying DLA's Agency-specific asbestos abatement cost factor to the square footage of each asset, resulting in asset-specific asbestos-related estimates. DLA's Agency-specific asbestos abatement cost factor was developed from asbestos surveys for the DLA host installations. For more detailed information on the development of the DLA Agency-specific asbestos abatement cost factor, refer to the DLA Asbestos Cost-Factor Methodology and Calculation document dated August 1, 2016.

DLA calculated the future cost associated with asbestos EL utilizing the Agency-specific asbestos abatement cost factor and the EBS real property records in compliance with the Department of Defense (DoD) Strategy for Environmental & Disposal Liabilities Audit Readiness (September 2015). Cost estimates related to DLA Asbestos EL were generated by multiplying the gross square footage of 4,753 DLA buildings and structures by the Agency-specific asbestos abatement cost factor of $1.27 per gross square foot (GSF). Additionally, applicable RACER location modifiers and Professional Labor Management (PLM) were factored on an asset by asset basis followed by systematic recognition of the liability over the remaining useful life of the asset in accordance with DoD FMR Volume 4 Chapter 13, Paragraph 130203 (April 2018).

Cleanup Costs Associated with Overseas Environmental Liabilities
Total overseas cleanup ELs include 1,079 environmental closure requirements sites (953 tanks and 126 pipelines) at 52 installations across 20 countries/territories, and two environmental corrective action sites at Royal Air Force Base Mildenhall, England. Additionally, there are 1,161 buildings/structures with overseas asbestos cleanup-related requirements at 50 installations across 22 countries/territories.

Cleanup Costs Associated with Non-Military Equipment Environmental Liabilities
The DLA does not currently report Non-Military Equipment EL. DLA is developing an auditable methodology for estimating the future cost of Non-Military Equipment EL utilizing FASAB Technical Release 11 Implementation Guidance on Cleanup Costs Associated with Equipment which determines relevant GE closure and disposal assets, the DLA GE inventory, and DLA's acquisition process. The inventory of DLA's GE assets was established using an EBS GE Asset Inventory Report.

Note 12. Other Liabilities - Unaudited

Other Liabilities as of September 30, 2018, consists of the following (in thousands):

	2018		
	Current Liability	Noncurrent Liability	Total
Intragovernmental			
Advances from Others	$ 363,680	$ -	$ 363,680
Judgment Fund Liabilities	192	-	192
FECA Reimbursement to the Department of Labor	9,159	14,172	23,331
Custodial Liabilities	2,752	-	2,752
Employer Contribution and Payroll Taxes Payable	21,288	-	21,288
Total Intragovernmental Other Liabilities	$ 397,071	$ 14,172	$ 411,243
Non-Federal			
Accrued Funded Payroll and Benefits	$ 238,785	$ -	$ 238,785
Advances from Others	11,891	-	11,891
Contract Holdbacks	-	18	18
Employer Contribution and Payroll Taxes Payable	113	-	113
Contingent Liabilities	927	8,386	9,313
Total Non-Federal Other Liabilities	$ 251,716	$ 8,404	$ 260,120
Total Other Liabilities	$ 648,787	$ 22,576	$ 671,363

As of September 30, 2018, DLA recorded a $363.7 million advance from FEMA related to hurricane relief efforts. DLA supported FEMA and other government entities for hurricanes Harvey, Irma, Maria, and Florence by supplying fuel, Meals Ready-to-Eat (MREs), equipment, water and other supplies.

Note 13. Commitment and Contingencies - Unaudited

Contingencies:

The DLA is a party in various administrative proceedings and legal actions related to claims for environmental damages, equal opportunity matters, and contractual bid protests. DLA has accrued contingent liabilities for legal actions where the Office of General Counsel considers an adverse decision probable and the amount of loss is estimable. In the event of an adverse judgment against the Government, some of the liabilities may be payable from the U.S. Treasury Judgment Fund. DLA records contingent liabilities (see Note 12) in Other Liabilities on the Balance Sheet.

Reasonably Possible Likelihood of an Adverse Outcome

The DLA has an estimated reasonably possible minimum loss contingency of $10.2 million. DLA's Automated Workflow and Reporting System (AWARS) is used by the Office of General Counsel to assess the outcomes and possible liability amounts of open cases. The AWARS projects a minimum liability of approximately $10.2 million and a maximum liability of approximately

$26.3 million. The minimum level decreased in FY2018 due to changes in the cases pending. Cases for which legal counsel are able to make a determination that an adverse outcome is reasonably possible and the possible financial outflow is measurable, are reported and disclosed as reasonably possible for financial reporting purposes.

Environmental Contingencies
The DLA has developed a process to identify and record contingent EL. Where DLA is aware of probable and measurable future outflow of resources due to a past event or exchange transaction, the appropriate program category will be reported in Environmental Liabilities and Disposal Liabilities (see Note 11).

Potential Loss Related to Economic Price Clause Contracts
The DLA is a party in numerous individual contracts that contain clauses, such as price escalation, award fee payments, or dispute resolution, that may result in a future outflow of expenditures. Currently, DLA has limited automated system processes by which it captures or assesses these potential liabilities; therefore, the amounts reported may not fairly present DLA's total contingent liabilities. Known contingencies that are considered both measurable and probable have been recognized as liabilities.

Unassessed Liability Cases
DLA identified 140 cases for which the DLA counsel is unable to express an opinion regarding the likely outcome of the case or the potential monetary outflow. These cases relate to Employee or Applicant Related (92 cases) and Contract Related matters (48 cases) with the potential exposure up to $2.8 billion.

Commitments:
The DLA WCF does not have obligations related to cancelled appropriations for contractual commitments.

Note 14. Exchange Revenue - Unaudited

The DLA WCF pricing policy for Supply Chain Management (SCM) and Energy Management is to seek full cost recovery of materiel and services while maintaining the goal to break even over a period of time. DLA establishes its selling or standard prices in the budget to ensure sufficient budgetary resources are available to cover costs of operations. The prices are normally stabilized or fixed during execution to mitigate the impact of unforeseen fluctuations. DLA will not change the prices during the fiscal year unless a prior approval from Office of the Undersecretary of Defense (Comptroller) OUSD(C) is received, with the exception of those instances in which the out-of-cycle price changes may be made without OUSD(C) approval.

The DLA SCM establishes the selling price primarily based on a base price and cost recovery rate (CRR). The base price is the average of acquisition and material related costs (e.g., testing and transportation). The CRR is a percentage added to the base price of items to allow recovery of the full costs of operations. The SCM reviews its selling prices on annual basis.

The DLA Energy Management generally bills its customers using a petroleum standard price mandated by OUSD(C). OUSD(C) and the Office of Management and Budget (OMB) establish the standard price for petroleum and product costs on an annual basis (see Note 1.T).

DLA recognized other accounting gains of approximately $2.0 billion and losses of approximately $2.0 billion derived from supply chain activities involving MAC updates, receipts without purchase orders, NRV updates, and disposal of demilitarized property. Accounting gains are included in exchange revenue and accounting losses are included in gross cost in the SNC. The SNC for Energy operations indicates that revenue exceeded expenses, however the events that produced this result were generated by the asset cleanup initiative performed by Energy in FY2018 and other inventory related adjustments resulting in increased gains. Assets were recorded in EBS as transfers-in, which were recorded in the gain account. DLA is unable to quantify which assets were proper transfers-in and which ones should not have been recorded as such.

Note 15. Apportionment Categories of New Obligations and Upward Adjustments: Direct vs. Reimbursable Obligations - Unaudited

Apportionment categories are determined in accordance with the guidance provided in OMB Circular A-11, *Preparation, Submission and Execution of the Budget*. The DLA WCF had both Direct and Reimbursable obligations in Category B (by program, project, or activity) for the year ended September 30, 2018. Category B did not contain obligations exempt from apportionment in FY2018. The table below summarizes the apportionment categories. The summation of the categories is equivalent to the New Obligations and Upward Adjustments Line on the Statement of Budgetary Resources:

Category B	As of September 30, 2018 (in thousands)
Direct New Obligations and Upward Adjustments	$ 25,119
Reimbursable New Obligations and Upward Adjustments	$ 52,562,463
Total	$ 52,587,582

Note 16. Undelivered Orders at September 30, 2018 - Unaudited

Undelivered Orders as of September 30, 2018 (in thousands)

	2018
Intragovernmental	
Unpaid	$ 1,321,181
Total Intragovernmental	1,321,181
Non-Federal	
Unpaid	20,567,816
Paid	78,827
Total Non-Federal	20,646,643
Total Undelivered Orders	$ 21,967,824

Undelivered Orders represent the amount of goods and/or services ordered to perform DLA's mission objectives, which have not been received. As of September 30, 2018, the DLA WCF does not have paid intragovernmental undelivered orders.

Note 17. Reconciliation of Net Cost of Operations to Budget - Unaudited

Reconciliation of Net Cost of Operations to Budget at September 30, 2018, consists of the following (in thousands):

		2018
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred	$	52,587,582
Less: Spending authority from offsetting collections and recoveries		(48,060,766)
Obligations net of offsetting collections and recoveries		4,526,816
Net obligations	$	4,526,816
Other Resources:		
Transfers in/out without reimbursement	$	154,719
Imputed financing from costs absorbed by others		177,879
Other		3,567
Net other resources used to finance activities		336,165
Total resources used to finance activities	$	4,862,981
Resources Used to Finance Items not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders	$	(4,515,677)
Unfilled Customer Orders		2,322,348
Resources that fund expenses recognized in prior periods		(15,797)
Resources that finance the acquisition of assets		(32,655,491)
Other resources or adjustments to net obligated resources that do not affect Net Cost of Operations:		
Other		(158,286)
Total resources used to finance items not part of the Net Cost of Operations	$	(35,022,903)
Total resources used to finance the Net Cost of Operations	$	(30,159,922)

Note 17. Reconciliation of Net Cost of Operations to Budget (Continued) – Unaudited

		2018
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Period:		
Increase in exchange revenue receivable from the public	$	(387,460)
Other		1,349
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	$	(386,111)
Components not Requiring or Generating Resources:		
Depreciation and amortization	$	307,375
Revaluation of assets or liabilities		(175,018)
Other		
Cost of Goods Sold		31,571,212
Other		(215,256)
Total Components of Net Cost of Operations that will not Require or Generate Resources	$	31,488,313
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	$	31,102,202
Net Cost of Operations	$	942,280

The Reconciliation of Net Cost of Operations to Budget provides information on the total resources used by DLA, both those received through the budget and those received by other means. It reconciles the budgetary obligations incurred to the net cost of operations for a given reporting period. It articulates and details the relationship between net obligations from budgetary accounting and net cost of operations from proprietary accounting.

Due to the DLA's financial system limitations, budgetary data does not agree with proprietary expenses and capitalized assets.

DLA WCF adjusted the note schedule in the amount of $67.3 million to bring it into balance with the Net Costs of Operations on the SNC, Statement of Net Position and Note 17. The adjustment is reported in Other Components Not Requiring or Generating Resources.

Required Supplementary Information

Deferred Maintenance and Repairs

The DLA WCF owns and manages five stewardship properties to support its mission. The maintenance and repair needs of these assets are identified primarily through the condition assessment process. Maintenance and repairs that were not performed when they should have been or were scheduled and delayed for a future period are considered deferred maintenance and repairs (DM&R).

M&R Policies. DLA is working with ERDC-CERL to develop a Sustainment Management System (SMS) for POL Facilities (FUELER) and to baseline assigned buildings using BUILDER. This effort will provide for systematic assessment of real property facilities and obtaining an SMS condition indexes which considers key life-cycle attributes such as age of components and materials.

M&R Prioritization. DLA Sustainment, Restoration and Maintenance (SRM) projects are planned, programmed, and executed according to the following priorities:

(1) Life, health, and safety concerns (cannot be mitigated);
(2) Security deficiencies (cannot be mitigated);
(3) Environmental deficiencies addressing non-compliance (cannot be mitigated);
(4) Warfighter support facilities (mission failure);
(5) Energy conservation projects (as mandated);
(6) Other Warfighter support facilities (mission impact); and
(7) Routine maintenance (no mission impact).

Acceptable Condition Standards. Generally, DLA considers an asset acceptable when it is in good condition with an assigned FCI of 80% or above. DLA also considers mission, health and safety, and quality of life when assessing acceptable conditions.

Capitalization of DM&R. The deferred maintenance and repair information presented relates to assigned use of DoD facilities and is not restricted to capitalized assets.

Asset Exclusions. The deferred maintenance and repair information excludes demolished facilities and facilities returned to the Servicing Components.

Real Property Deferred Maintenance and Repairs as of September 30, 2018 (in thousands):

		Beginning Balance		Ending Balance
Active				
Category 1: Building, Structures, and Linear Structure (Enduring Facilities)	$	466,000	$	1,086,370
Category 2: Building, Structures, and Linear Structure (Heritage Assets)		200		832
Total Active	**$**	**466,200**	**$**	**1,087,202**
Inactive and Excess				
Category 3: Building, Structures, and Linear Structure (Excess Facility or Planned for Replacement)	$	13,600	$	-
Total Inactive and Excess	**$**	**13,600**	**$**	**-**
Total Deferred Maintenance	**$**	**479,800**	**$**	**1,087,202**

Combining Statement of Budgetary Resources

The Combining Statement of Budgetary Resources combines the availability, status, and outlays of the DLA WCF's budgetary resources for the fiscal year ended September 30, 2018. The following table provides the Combining Statement of Budgetary Resources disaggregated by WCF activities.

Defense Logistics Agency-Working Capital Fund
Combining Statement of Budgetary Resources
For the Year Ended September 30, 2018
(In Thousands)

	Document Services	Energy	Supply Chain Managment	Total
Budgetary Resources:				
Unobligated balance from prior year budget authority, net (discretionary and mandatory)	$ 170,730	$ 18,520	$ 307,800	$ 497,050
Appropriations (discretionary and mandatory)	-	760,562	75,863	836,425
Contract Authority (discretionary and mandatory)	-	17,922,019	34,355,783	52,277,802
Spending Authority from offsetting collections (discretionary and mandatory)	292,293	650	-	292,943
Total Budgetary Resources	**$ 463,023**	**$ 18,701,751**	**$ 34,739,446**	**$ 53,904,220**
Memorandum (non-add) entries:				
Net adjustment to unobligated balance brought forward, Oct 1	$ 13,650	$ -	$ -	13,650
Status of Budgetary Resources:				
New obligations and upward adjustments (total)	$ 333,881	$ 17,838,828	$ 34,414,873	$ 52,587,582
Unobligated balance, end of year				
Apportioned, unexpired accounts	129,142	862,923	324,573	1,316,638
Unexpired unobligated balance, end of year	129,142	862,923	324,573	1,316,638
Unobligated balance, end of year (total)	129,142	862,923	324,573	1,316,638
Total Budgetary Resources	**$ 463,023**	**$ 18,701,751**	**$ 34,739,446**	**$ 53,904,220**
Outlays, net				
Outlays, net (total) (discretionary and mandatory)	$ 2,453	$ 1,141,886	$ (30,569)	$ 1,113,770
Agency Outlays, net (discretionary and mandatory)	**$ 2,453**	**$ 1,141,886**	**$ (30,569)**	**$ 1,113,770**

Audit Reports

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

November 14, 2018

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

SUBJECT: Transmittal of the Independent Auditor's Report on the Defense Logistics Agency Working Capital Fund Financial Statements and Related Notes for FY 2018 (Project No. D2018-D000FE-0093.000, Report No. DODIG-2019-025)

We contracted with the independent public accounting firm of Ernst & Young, LLC, (EY) to audit the Defense Logistics Agency (DLA) Working Capital Fund FY 2018 Financial Statements and related notes as of September 30, 2018, and for the year then ended, and to provide a report on internal control over financial reporting and compliance with laws and regulations. The contract required EY to conduct the audit in accordance with generally accepted government auditing standards (GAGAS); Office of Management and Budget audit guidance; and the Government Accountability Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2008.[1] EY's Independent Auditor's Reports are attached.

EY's audit resulted in a disclaimer of opinion. EY could not obtain sufficient, appropriate audit evidence to support the reported amount within the DLA Working Capital Fund financial statements. As a result, EY could not conclude whether the financial statements and related notes were fairly presented in accordance with Generally Accepted Accounting Principles. Accordingly, EY did not express an opinion on the DLA Working Capital Fund FY 2018 Financial Statements and related notes.

[1] In June 2018, the Government Accountability Office issued an updated Financial Audit Manual. EY updated its audit procedures to be in accordance with the updates issued in the Government Accountability Office/Council of the Inspectors General on Integrity and Efficiency, "Financial Audit Manual," June 2018.

EY's separate report on "Internal Control over Financial Reporting" discusses eight material weaknesses related to the DLA's internal controls over financial reporting. Specifically, EY found material weaknesses including: Inventory; Property, Plant, and Equipment; Fund Balance with Treasury; Accounts Receivable; Accounts Payable; Financial Reporting; Oversight and Monitoring; and Information Systems. EY's additional report on "Compliance and Other Matters" discusses two instances of noncompliance with applicable laws and regulations.

In connection with the contract, we reviewed EY's report and related documentation and discussed the audit results with EY representatives. Our review, as differentiated from an audit in accordance with GAGAS, was not intended to enable us to express, and we did not express, an opinion on the DLA Working Capital Fund FY 2018 Financial Statements and related notes, conclusions about the effectiveness of internal control, conclusions on whether the DLA's financial systems substantially complied with the "Federal Financial Management Improvement Act of 1996," or conclusions on whether the DLA complied with laws and regulations.

EY is responsible for the attached reports, dated November 14, 2018, and the conclusions expressed in these reports. However, our review disclosed no instances in which EY did not comply, in all material respects, with GAGAS.

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

Lorin T. Venable

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

Attachments:
As stated

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Report of Independent Auditors

The Director of the Defense Logistics Agency and
The Inspector General of the Department of Defense

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of the Working Capital Fund of the Defense Logistics Agency ("DLA"), which comprise the balance sheet as of September 30, 2018, and the related statements of net cost, changes in net position, and combined statement of budgetary resources for the year ended September 30, 2018, and the related notes to the financial statements ("financial statements").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that is free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and the Office of Management and Budget Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Departure from U.S. Generally Accepted Accounting Principles

As described in Note 1, DLA has not implemented certain accounting standards required for the Department of Defense and the Federal government. The effect on the financial statements amounts involved is not currently determinable by DLA and could be material.

Basis for Disclaimer of Opinion

DLA continues to have unresolved accounting issues and material weaknesses in internal controls that cause DLA to be unable to provide sufficient evidential support for complete and accurate financial statements on a timely basis. As a result, we cannot determine the effect of the lack of sufficient appropriate audit evidence on DLA's financial statements as a whole for the year ended September 30, 2018.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States require that the Management's Discussion and Analysis and Required Supplementary Information, as listed in the Table of Contents, be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We were unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph. We do not express an opinion or provide any assurance on the information.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise DLA's basic financial statements. The Other Information, as identified on DLA's Agency Financial Report Table of Contents, is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The Other Information, as listed in the Table of Contents, has not been subjected to the auditing procedures applied in the engagement to perform an audit of the financial statements, and, accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we also have issued our reports dated November 14, 2018 on our consideration of DLA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. Those reports are an integral part of an engagement to perform an audit in accordance with *Government Auditing Standards* in considering DLA's internal control over financial reporting and compliance.

Ernst & Young LLP

November 14, 2018

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Report of Independent Auditors on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Director of the Defense Logistics Agency and
The Inspector General of the Department of Defense

We were engaged to audit, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and the Office of Management and Budget ("OMB") Bullet No. 19-01, *Audit Requirements for Federal Financial Statements*, the financial statements of the Working Capital Fund of the Defense Logistics Agency (DLA), which comprise the balance sheet as of September 30, 2018, and the related statements of net cost, changes in net position, and combined statement of budgetary resources for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated November 14, 2018. That report states that because of matters described in the Basis for Disclaimer Opinion paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements as of and for the year ended September 30, 2018 and the related notes to the financial statements.

Internal Control over Financial Reporting

In connection with our engagement to audit the financial statements, we considered DLA's internal control over financial reporting ("internal control") to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of DLA's internal control. Accordingly, we do not express an opinion on the effectiveness of DLA's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 19-01. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 ("FMFIA"), such as those controls relevant to ensuring efficient operations.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. As described below, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

Material Weaknesses

During our audit, we identified the following matters involving internal control over financial reporting and its operation that we consider to be material weaknesses as defined above:

I. Inventory – Inventory comprises items held by DLA for resale or held by DLA on behalf of one of the military services. We found that policies, procedures, and controls surrounding documentation of procurements and disbursements, tracking of inventory by owner, challenging the perpetual inventory systems by periodic physical counts, accumulating cost of inventory, and adequately supporting inventory balances and transactions all had deficiencies that in combination signified a material weakness in internal control related to inventory. The matters identified related to inventory are further described in Appendix A.

II. Property, Plant, and Equipment (PP&E) – PP&E includes real property, general equipment, internal use software, and construction-in-progress. We found that DLA has not completed an analysis of existence and completeness of PP&E records for which they are the financial reporting organization (FRO), had not completed their process to value PP&E beginning balances, and has weaknesses in the processes of maintaining and reconciling PP&E records. The combination of these findings led us to conclude that there is a material weakness related to PP&E. The matters identified related to PP&E are further described in Appendix A.

III. Fund Balance with Treasury (FBwT) – DLA is unable to reconcile the FBwT ending balances from the general ledger directly to the U.S. Treasury. DLA, in conjunction with Defense Finance and Accounting Services (DFAS), has implemented the Cash Management Reconciliation (CMR) and Department 97 Report Reconciliation Tool (DRRT) processes as mechanisms to reconcile DLA's general ledger to Treasury. However, these tools have known control deficiencies and reconciling issues within the process. In addition, DLA does not have sufficient policies, procedures or controls in place for the end-to-end FBwT process. These deficiencies supported a conclusion of a material weakness in FBwT. The matters noted are further described in Appendix A.

IV. Accounts Receivable (AR) – AR consists of amounts owed to DLA primarily related to resale of goods. We found that DLA was unable to adequately support the balances included in the accounts receivable detail, had not adequately validated or explained the significant balance of aged receivables, did not have adequate procedures to estimate valuation allowances against receivables, and had not adequately supported transactions recorded. The combined effect of these weaknesses led us to conclude there is a material weakness related to accounts receivable. The matters identified related to AR are further described in Appendix A.

V. Accounts Payable (AP) – AP represents the amount owed to third parties by DLA for goods and services received, whether or not an invoice has been received. We found that DLA was unable to adequately support the accounts payable and related budgetary balances; had issues recording transactions in the proper period; lacked overall policies, procedures, and internal controls in the procure to pay process; including the process to create and approve obligations and the process to review, record and pay invoices; and did not have adequate procedures to accrue for obligations incurred but not paid. This combination of deficiencies is considered to be a material weakness. The matters identified related to AP are further described in Appendix A.

VI. Financial Reporting – DLA's financial statement preparation process lacks sufficient, appropriate reviews to identify inaccurate balances on the face of the financial statements as well as completeness and accuracy of disclosures. In addition, we found that DLA lacks policies and procedures to validate budgetary account balances and monitor budgetary reporting variances between source systems, resulting in DLA recording unsupported journal vouchers to correct the variances. We considered these deficiencies to be a material weakness. The matters noted are further described in Appendix A.

VII. Oversight and Monitoring - DLA does not have an effective OMB Circular A-123 program, which impacted DLA's ability to appropriately identify and address significant risks for all key business processes. DLA has not implemented appropriate internal controls, including the documentation of policies and procedures that describe DLA's environment related to end-to-end business processes, roles, and responsibilities, and monitoring of service providers, related parties, systems, risks, and controls. DLA's lack of documented controls prevent the consistent execution and proper review of data/reports used in the execution of key controls, as well as appropriate evidence of management review controls. We consider these overall weaknesses in the internal control structure to be a material weakness. The matters noted are further described in Appendix A.

VIII. Information Systems – Our assessment of DLA's information technology (IT) controls and the computing environment identified deficiencies which collectively constitute a material weakness in the design and operation of information systems controls over financial data. We reviewed each finding individually, as well as in aggregate. Based on our review, we have identified four areas of deficiency which, when aggregated, result in a material weakness. The deficiencies relate to the following four areas:

- Access controls / user access
- Configuration management / change controls
- Segregation of duties controls
- Security management / governance over implementation of security controls

Refer to Appendix A for additional detail in these four areas.

Significant Deficiencies

During our audit, we also noted the following matter involving internal control over financial reporting and its operation that we consider to be a significant deficiency, as defined above:

I. Environmental Liabilities (EL) – Environmental liabilities comprise clean-up costs associated with the restoration of sites on real property that DLA manages. The lack of formal policies, procedures, and supporting documentation does not allow for DLA to substantiate the completeness and valuation of its EL. The matters identified related to EL are further described in Appendix B.

DLA's Response to Findings

DLA's response to the findings identified in our engagement, as described above, is included in its letter dated November 14, 2018, which has been included at the end of this report. DLA's response was not subjected to the auditing procedures applied in the engagement to audit the financial statements and, accordingly, we express no opinion on it. The status of prior year instances of deficiencies is presented in Appendix C.

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Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control. This report is an integral part of an engagement to perform an audit in accordance with *Government Auditing Standards* in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

Ernst + Young LLP

November 14, 2018

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Appendix A - Material Weaknesses

I. Inventory

DLA's inventory comprises petroleum and aerospace products, weapon system repair parts, food, clothing, and medical supplies. Inventory also includes material from the military services designated for disposal or reutilization. Control over the inventory process is complex because of the large number of locations in which inventory is stored, the volume of different items held, and the specific requirements imposed by the individual branches of the military service. To meet these challenges, DLA must have controls over processes of procurement and introduction of goods into inventory, delivery of goods to customers, and periodic reconciliation of goods on hand to accountability and financial records. In our testing, we found that DLA's controls and processes did not adequately meet these needs in several significant areas. Specifically:

DLA lacks policies and procedures that adequately describe the end-to-end process to account for and report inventory and inventory-related transactions due to the following:

- DLA inventory process cycle memos, policy memorandum, or standard operating procedures do not adequately document the flow of transactions and related internal control activities. Specifically, DLA has not documented the processes related to the significant business activities for acquisition, movement, warehousing, and disposition of inventory; the related risks for each business activity; and the control activities designed to mitigate risk of loss or material misstatement.
- The process documentation does not adequately include a description of inventory financial reporting, inventory records management, physical inventory count policies, accounting for third-party managed inventory, and various other business processes.
- The process documentation also does not include the description or significant operating protocols surrounding the inventory reconciliation framework or the annual Chief Financial Officer (CFO) sample process.
- DLA has not adequately identified and documented the risks of material misstatement and corresponding controls associated with the inventory business processes. As such, DLA's internal control environment is not sufficient to mitigate risks to the financial statements.

DLA has not appropriately designed controls related to physical counts for the validation of existence and completeness of inventory due to the following:

- Supply inventory
    - Industry practice in inventory cycle count programs is a requirement that all inventory is counted at least once annually. DLA policy requires the physical count of all items on two or five year cycles depending on inventory value. DLA is not currently in compliance with this policy.

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- DLA has instituted an annual statistical sampling count to supplement the cycle counts and mitigate potential weaknesses in the cycle count control. However, the statistical sampling approach was not executed completely and accurately. The sampling approach used in prior fiscal years was not designed to include all inventory. In addition, errors identified in the sample were not assessed to determine the root cause or projected over the population to determine the potential financial significance of the errors noted over the entire population.

- Aerospace inventory – DLA is unable to demonstrate that periodic physical counts or measurements of Aerospace inventory are performed to validate the existence and completeness of inventory. DLA primarily relies on perpetual records to account for and report Aerospace inventory.

DLA lacks policies and procedures to properly segregate inventory held for others and ensure gains and losses recorded as a result of physical inventory counts are properly assigned to the appropriate owner due to the following:

- DLA does not properly segregate inventory held for others from inventory owned by DLA. As a service to the military, in addition to procuring and holding inventory for the military, it also manages certain inventory procured directly by the military and delivered to DLA. This inventory held on behalf of the military services is not always stored in physically segregated locations and instead is comingled with similar inventory owned by multiple owners.
- DLA's inventory systems track quantities of inventory by owner but does not reconcile those records to the total physical inventory counts on a regular basis.
- DLA policy states that DLA does not accept the risk of loss for inventory held by DLA on behalf of others. However, policies or procedures are not in place to ensure that gain/loss adjustments are appropriately assigned to the appropriate owner. DLA policy states that upon completion of inventory counts, gains and losses are assigned based on a proration methodology. In certain instances, the gains and losses are entirely recorded by DLA, as the manager of the inventory, regardless of the ownership. Gains and losses recorded by DLA for inventory held by DLA on behalf of others does not comply with their policy.
- Policies are not adequate to ensure gains/losses recognized in the financial statements are complete and accurate.

DLA is unable to substantiate the completeness and accuracy of disposition inventory received from the military services due to:

- Inventory physical counts are not required to be performed on all disposition inventory received from the military services. DLA policy requires that prior to transferring the inventory into DLA disposition from the military services, a physical count is only performed under specific circumstances. If certain criteria are not met, a physical count is not required to be performed. The inventory count policies are not adequate to ensure existence and completeness of all inventory received is recorded appropriately.

DLA is unable to substantiate the existence and completeness of inventory held at third parties due to:

- A detailed listing of all vendors who hold inventory on DLA's behalf was unavailable to the auditors.
- A detailed listing of inventory by vendor that reconciles to the inventory recorded in DLA's general ledger, Enterprise Business System (EBS), was unavailable to the auditors.
- Sufficient evidential matter to support the balances of inventory held at third parties for each vendor was unavailable. Due to the lack of evidential matter, confirmations could not be completed to validate the inventory held at third parties. In addition, differences in inventory balances between the third party and DLA could not be reconciled due to the lack of evidential matter.
- DLA does not have adequate controls in place to periodically review the EBS inventory listing to validate inventory is recorded at active vendors. We found that DLA recorded inventory at inactive vendors (i.e. vendors with which DLA no longer has a contractual relationship).

DLA lacks appropriate controls to ensure compliance with and consistent application of DLA Energy policies and procedures:

- DLA policy requires that manual readings of fuel tank levels be obtained by calibrated tape or calibrated rod in the absence of functional automated tank gauging (ATG) systems. DLA does not have processes in place to ensure that manual readings are used for malfunctioning ATGs.
- DLA policy requires that monthly or quarterly ATG verifications are performed. DLA does not perform procedures to monitor and review that field level sites perform the monthly or quarterly verifications.
- DLA policy requires that a work order is submitted for all malfunctioning ATGs to be recalibrated. However, DLA does not have sufficient monitoring controls in place to determine if work orders are completed.

DLA lacks policies and procedures to properly validate in-transit inventory due to the following:

- Policies and procedures are not in place to validate that DLA has accepted title and has the right to record inventory in-transit from procurement.
- In-transit inventory comprises inventory that was accepted at the point of origin (FOB shipping point) and in-transit to a DLA destination. We found circumstances wherein inventory was recorded as in-transit from procurement points of origin and has remained in-transit for several fiscal years, including amounts dating back to 2008.

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DLA lacks adequate controls to ensure that transactions between the accountable property system of record (APSR) and EBS are posted appropriately due to the following:

- Controls are not in place to prevent users from posting above their approved thresholds nor to review if users posted unauthorized transactions. Transactions posted in the APSR are reconciled to transactions posted in EBS. Errors identified in the data recorded between the systems result in that transaction being flagged. DLA policy requires that the errors are reviewed and corrected by assigned users. Adjustments above a certain dollar threshold are reviewed by a supervisor. However, DLA does not have a process that prevents users from posting adjustments above the threshold or detect that adjustments posted above the threshold were reviewed.
- Controls are not in place to ensure that a review is performed on adjustments that were made to detect whether an unauthorized adjustment was made.

DLA lacks adequate controls to ensure that inventory is complete, accurate, appropriately valued, and presented due to the following:

- Costing – DLA does not have adequate controls in place to properly value inventory in accordance with Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 48, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials*. DLA began implementing inventory costing methodologies in accordance with FASAB SFFAS No. 48 in fiscal year (FY) 2016. However, DLA did not completely and accurately value inventory in accordance with SFFAS No. 48.
    - In applying SFFAS No. 48, the values assigned for certain inventory items were based on the latest acquisition cost (LAC). The LAC values did not properly consider inventory acquired through the implementation date.
    - Purchase discounts and/or additional costs to get the material to the suitable form and location of its intended use were not considered when calculating the LAC.
- Costing – DLA does not have adequate controls in place to properly value inventory in accordance with SFFAS No. 3, *Accounting for Inventory and Related Property*.
    - DLA policy is to value inventory using the moving average price (MAP). However, DLA is unable to provide the complete and accurate detailed listing of costs that are used to calculate the MAP.
    - We found that DLA excludes certain costs in calculating the MAP. However, DLA is unable to provide the listing of costs excluded from the MAP or demonstrate that costs excluded from the MAP are not material.
- Work in process (WIP) – DLA does not properly account for additional inventory costs associated with WIP inventory while the inventory is in the kitting or assembly process. Inventory items or components are provided to a production facility, for assembly, modification, or to make an end-item. DLA policy is to classify the raw materials provided to a vendor for kitting or assembly as inventory stock on hand until the finished goods are produced and a goods receipt is posted. Upon receipt, the raw materials are decremented

and the finished good is recorded. Policies and procedures are not in place to assign and record all costs, such as the assembly and labor costs, incurred during the kitting or assembly process.

- Inventory valuation allowances – DLA lacks policies and procedures to ensure that the valuation of inventory, including excess, obsolete and unserviceable (EOU) inventory, inventory held for repair, inventory held at net realizable value, etc., is in accordance with generally accepted accounting principles (GAAP) due to the following:
  - Inventory held for repair:
    - The policy documentation did not sufficiently describe the methodology used to estimate the allowance for inventory held for repair.
    - The policy did not describe the rationale for adopting the methodology being used and the factors used in the estimation process.
  - EOU:
    - Policies or procedures are not in place to identify and properly value inventory held by third parties which is excess, obsolete, or unserviceable.
    - Adequate controls are not in place to ensure the net realizable value applied to EOU inventory is calculated correctly.
- Inventory presentation – DLA does not have adequate policies and procedures in place to ensure that inventory is assigned to the appropriate condition codes and that the balances in inventory general ledger accounts are appropriately valued and presented in the financial statements.

DLA lacks adequate controls in place to ensure the balances at period end are complete and accurate due to the following:

- Policies and procedures are not in place to ensure transactions are appropriately and accurately recorded in the period that the transaction occurred.
- DLA does not have a process to accrue for transactions that occurred but were not posted at period end.
- Internal controls are not in place for detecting and resolving timely the posting errors during the interfaces between the accountable property systems of record (APSR) and the general ledger (EBS).

DLA has not adequately designed controls to ensure that inventory is reconciled between the APSR and EBS on a complete and timely basis:

- DLA does not have adequate processes in place to reconcile inventory balances effectively. DLA utilizes the Inventory Reconciliation Framework (IRF) to reconcile inventory. The IRF compares the inventory quantity balance in EBS to the inventory quantity balance in the Inventory Record Management (IRM)-compliant APSRs. The IRF comprises ten tie points of both financial and quantity data. However, DLA does not complete the inventory reconciliation on a timely basis or within their normal financial statement close period (approximately 30 days from month end). Therefore, DLA was unable to provide the

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reconciliation for September 2018 prior to the report date. Additionally, there were significant unreconciled variances totaling $718 million in the reconciliation for June 2018.

- The IRF does not include all appropriate general ledger accounts such as inventory in-transit between storage locations, inventories-stock on hand, etc.
- DLA is unable to substantiate how variances are reconciled. DLA provides the causative and non-causative research worksheet to support how variances are resolved. However, the worksheet is not adequate to support the cause of the variance and how the adjustment properly corrected the variance.

DLA is unable to substantiate that transactions are recorded consistently with Treasury's United States Standard General Ledger (USSGL) accounting transaction definitions and processing rules and to trace transaction detail supporting USSGL accounts to USSGL account codes due to the following:

- DLA does not have sufficient evidential matter that documents the posting logic for inventory transactions (inventory receipts, issues, gains, losses, and condition change), including which general account should be used and how the values of each general ledger entry are calculated. DLA utilizes multiple APSRs that transfer financial transactions to the general ledger in EBS. The financial transactions result in adjustments to inventory balances (e.g. inventory receipts, issues, gains, losses, and condition change), which trigger a movement type through an existing interface. The movement types are configured to update the inventory ledger in EBS and the inventory stock on hand general ledger account.
- DLA was unable to provide an accurate mapping of the EBS posting logic to the APSR document identifier codes (DIC) and EBS movement types. DLA's documentation demonstrated the DICs being mapped to several movement types, which resulted in different posting logics being used.
- The posting logic for various inventory transactions does not comply with the guidance outlined in the Treasury Financial Manual (TFM) such as recoupment from disposal, material transfers, etc. The transactions do not meet the corresponding TFM business events.

DLA lacks adequate controls to ensure that inventory is classified and presented appropriately in the financial statements due to the following:

- Controls are not in place to ensure that inventory balances are appropriately recorded and reported in the financial statements. DLA accounting policy states that inventory balances are based on the following categories: inventory held for current sale, inventory held for future sale, EOU and inventory held for repair. However, DLA lacks policies and procedures to identify excess inventory and to ensure that inventory classified as EOU meets the definition in SFFAS No. 3, *Accounting for Inventory and Related Property*.
- Controls are not in place to ensure that inventory is assigned to the appropriate condition codes and that the balances in inventory general ledger accounts are complete and accurate. DLA uses the inventory condition codes as the basis to classify inventory between each

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category.

- Policies and procedures are not in place to identify and classify inventory as not available for sale for both inventory held by DLA and inventory held at third parties.

DLA is unable to substantiate inventory and inventory-related transactions due to the following:

- DLA is unable to provide evidential matter to support that inventory balances exist or inventory transactions occurred and are accurately recorded in the financial statements. Specifically, documentation was not available to support:
  - Whether transactions recorded in EBS and Fuels Manager Defense (FMD) were complete and accurate.
  - Transactions recorded in EBS.
  - Shipping terms for sales transactions to evidence when the title and risk of loss is transferred to the buyer.
  - Transactions were recorded appropriately when title transfer occurs at origin.
  - Balances recorded in the inventory detail reports from EBS does not reconcile to the site-specific end of month report and component financial statements.
  - Whether transactions for Defense Fuel Support Point (DFSP) service stations were complete and accurate.
  - Balances of fuel inventory held in pipelines or in-transit between storage locations.
  - Posting of transactions in the general ledger resulting from financial events (i.e. sales, purchases, gains and losses).
  - Gain and loss transactions recorded in EBS, including gains and losses resulting from physical inventory counts.

DLA is unable to substantiate that the transaction data in EBS and Fuels Manager Defense (FMD) is complete and accurate due to:

- DLA implemented an upgrade to FMD during FY2018 for various field level fuel sites. Subsequent to completing the implementation, DLA found that various types of erroneous transactions were processed in EBS. To remediate the issues, DLA performed various analyses to assess the pervasiveness of the errors and implemented system changes.
- Policies and procedures are not in place requiring evidential matter to be maintained that demonstrate that the analyses were performed, the analyses were sufficiently precise, and the basis for the conclusions reached.
- DLA is unable to demonstrate that erroneous transactions or anomalies in financial transactions that were recorded and corrected in FMD are complete and accurate.

Recommendations

EY recommends that DLA consider the following corrective actions related to the deficiencies identified above:

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- Update and finalize the process cycle memoranda (PCMs) that document the end-to-end processes for inventory, including receiving, distributing, recording, processing, and reporting. Process owners review and sign off on the updated PCMs to validate that the PCMs are complete and accurate. The process to update and finalize the PCMs should be included in the Manager's Internal Control Program (MICP).
- Perform risk analysis and document risks associated with the DLA inventory business process. Review current control documentation and perform a gap analysis for internal controls at the financial statement assertion level. Develop comprehensive documentation demonstrating that the controls mitigate the risk of material misstatement.
- Design and implement inventory count policies and procedures for which the following objectives are met:
    - Add a requirement to the inventory processes whereby quantities in the perpetual inventory system are supported via physical counts at least once a year either through a wall-to-wall year-end count or adequately designed cycle counts.
    - Test the effectiveness of the perpetual inventory system by refining the CFO sample inventory count program whereby DLA executes counts on materiel selected using statistical sampling and the errors are appropriately projected to the population, including testing for existence, classification, etc., including the following:
        - Performing procedures to verify that the inventory population used to select the CFO Sample is complete and accurate, such as reconciling the population used to the general ledger, verifying that the data include the relevant data fields such as price, etc.
        - Establishing and documenting a policy supporting the methodology used to determine the inventory population (i.e. justify the amounts that are included or excluded from the population)
        - Establishing and documenting a policy supporting the methodology used to calculate the materiality threshold used in the CFO sample count procedures, including the assessment that the materiality thresholds are sufficiently precise and sensitive enough to identify errors at the appropriate level
        - Establishing a policy to evaluate whether the changes in condition code identified during the sample are considered errors, since valuation may be impacted
        - Performing adequate research over materiel with zero dollar MAP to record the correct value and to properly classify the material in the appropriate statistical strata in the sample design
        - Establishing and documenting a formal methodology to extrapolate errors and the procedures to extrapolate those errors are supported by evidential matter
        - Establishing a formal policy to validate EBS inventory balances for each sample selection made in the CFO sample.
- Perform a reconciliation of third party managed inventory balances to EBS balances prior

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to making adjustments from physical inventory counts.

- Design policies and procedures related to inventory held for others to include the following:
    - Policies and procedures to properly identify the inventory owner of the materiel, such as identifying the owner on materiel labels upon receipt
    - Policies and procedures that segregate the inventory by owner, in order for DLA to efficiently and effectively manage DLA-owned inventory and inventory held on behalf of others.
    - Policies and procedures to record inventory gains/losses for inventory held on behalf of other to the appropriate owner to properly account for the gains/losses, as well as comply with fiscal law.
    - Policies and procedures to ensure compliance with laws and regulations (e.g. Antideficiency Act)
    - Revise type of physical inventory count (TPIC) T inventory criteria to include all disposition (S9W) items received from other services
    - Add additional procedures to ensure inventory exists prior to being recorded on DLA's financial statements
    - Implement policies and procedures related to inventory held at third parties to ensure the following: A reconciliation is performed on a monthly basis to reconcile detailed inventory balances by vendor to EBS inventory listings, including all variances being investigated
    - Evidential matter exists to support the comprehensive listing of vendors and military services which hold DLA-owned inventory on behalf of DLA (e.g. an EBS export with vendor plant codes, vendor names, associated balances tied to the MB5L report)
    - The names of third party vendors and military service can be cross walked to EBS plant codes
    - Evidential matter exists to support individual vendor balances for EBS plant codes which are used for multiple vendors (e.g. an EBS export listing the inventory balance by vendor name).
- Design policies to include procedures to monitor the results of the DFSP's manual measurement to ATG verification. The procedures that were completed to verify the ATG should be documented to demonstrate that the control activity was operating effectively. For sites with out of tolerance ATGs, DLA should track and monitor the recalibration of the ATG system to ensure that the resolution is completed in a timely manner. DLA should also monitor that the site performs manual measurements on out of tolerance tanks during the period the tank is considered out of tolerance.
- Develop and implement comprehensive policies and procedures to review in-transit inventory to ensure balances are complete and accurate, that DLA owned materiel exists, and DLA has rights to the materiel.
    - Establish appropriate policies and procedures that outline the criteria or thresholds that should be used when in-transit inventory transactions during the review process

- Develop and implement policies and procedures to monitor the Major Subordinate Commands' (MSC) compliance with DLA policies.
- Update policies and procedures to properly record the appropriate inventory costs in the general ledger in accordance with the United States Standard General Ledger (USSGL) and SFFAS No. 3 as follows:
  - Implement a process to track and record additional costs to bring items to their intended form and location to USSGL 152600 and the finished goods
  - Update EBS posting logic to record materiel in the kitting phase(s) of the stock provided to vendor (SPTV) process to USSGL 152600
  - Perform a management review of EBS posting logic to ensure compliance with Treasury's Financial Manual
- Design application controls that limits users to postings transactions within their approved thresholds. Further, DLA's inventory process should include procedures to review transactions posted to verify that unauthorized transactions were not posted.
- Evaluate current inventory policies and procedures related to implementation of deemed cost valuation methodologies in accordance with SFFAS No. 48 and ensure:
  - Documentation outlining the implementation of SFFAS No. 48 provides a sufficient description of the process, as well as application of SFFAS No. 48
  - Procedures performed to verify completeness and accuracy of data obtained from Invoicing, Receipt, Acceptance, and Property Transfer (iRAPT) and EBS are documented
  - Valuation methodologies used are based on the best available information to arrive at an alternate value
  - DLA considers all costs necessary to get an item to a form and location suitable for its intended use when valuing materiel based on LAC
  - DLA has a supportable methodology to value Disposition Services inventory that complies with either SFFAS No. 48 (when establishing beginning balances) or SFFAS No. 3 (upon implementing SFFAS No. 48)
  - DLA establishes and implements policies and procedures to value inventory that comply with SFFAS No. 3 on a go forward basis
  - Management reviews the implementation methodology to ensure compliance with GAAP.
  - Evidential matter (e.g. policies and procedures) which documents steps taken to ensure consistent application
- Design policies and procedures related to inventory allowances to include:
  - Documentation describing the methodology and processes used to estimate the allowance for inventory held for repair.
  - Policies and procedures to derive estimates used in the calculation of the repair allowance.
  - Policies and procedures to assess the completeness and accuracy of the data populations.
  - Policies and procedures to document management's review for compliance with generally accepted accounting principles.

- Design and implement policies and procedures to properly classify inventory into the appropriate condition codes and to properly ensure the amounts presented in the financial statements are based on the correct condition codes.
- Design the inventory management process and related internal control activities to include procedures to identify excess, obsolete, or unserviceable inventory held at third parties. Further, these procedures should include an analysis to assess the value of the excess, obsolete or unserviceable inventory and record these inventories at the lower of cost or net realizable value.
- For calculating the NRV, design policies and procedures to include the following:
  - Review the methodologies used in the NRV calculation to ensure estimated costs of completion, holding and disposal are complete and accurate.
  - Ensure methodologies used to estimate recoveries from sale of materiel are documented and supported.
  - Have policies and procedures that include standards for maintaining evidential matter to support inputs to the NRV calculation.
  - Consider implementing and documenting a single methodology for all EOU inventory, when appropriate.
  - Implement policies and procedures to ensure the NRV calculation considers data from the most recent fiscal year plus the previous two fiscal years in accordance with the Department of Defense (DoD) Financial Management Regulation (FMR).
  - Implement management review procedures to ensure that the valuation methodology and the application of the methodology is in compliance with GAAP and DoD policies.
- Design policies, procedures, and controls to ensure transactions are processed and posted to the correct period in EBS and that an accrual is recorded at period-end for transactions that should be posted to reflect recording in the proper period, but have not been resolved. Furthermore, DLA's inventory process should include policies and procedures to review the remainder of the IRM reports and the intermediate document (IDOC) failure review process.
- Design policies and procedures related to timely reconciliation of inventory subsidiary ledgers to EBS to include the following:
  - Policies and procedures to ensure difference reports are reviewed and variances are reconciled or resolved timely.
  - Policies and procedures to adequately support how variances are resolved.
  - Policies and procedures to identify reconciling differences due to timing and ensure adjustments are not processed for variances which self-correct (i.e. timing differences).
  - Policies and procedures to reconcile all inventory general ledger accounting codes (GLACs) to the sub-ledger.
  - Policies and procedures requiring that items that are removed from the differences report are properly documented and resolved.
  - Policies and procedures to standardize treatment of common errors, unreconciled items, and adjustments to APSRs or EBS.

  - Policies and procedures to assess whether trends exists for various error types, in order to identify and/or resolve systemic issues within business processes.
  - Policies and procedures for establish thresholds for variances that require for a review to be performed.
- Ensure evidential matter to support posting logic utilized for recording inventory transactions in EBS includes the following:
  - A system-generated mapping which ties EBS configured posting logic to EBS transaction codes and movement types, TFM transaction numbers, and business events interfaced from APSRs.
  - Clear descriptions of business events and varying circumstances which impact or change the posting logic.
  - Documentation over the process to calculate the dollar value of each general ledger entry.
  - Evidence that a review is performed by management to ensure that the posting logic is in compliance with the TFM.
- Design and implement policies and procedures related to classifying inventory to include the following:
  - The policies and procedures for how supply centers should assign inventory items to the appropriate condition code once a supply discrepancy report (SDR) is submitted.
  - The policies and procedures for how inventory is identified as excess, obsolete, or unserviceable and how condition codes for such inventory are subsequently updated.
  - The policies and procedures that differentiate inventory items in condition codes A-D that should be accounted under the account Held for Future Sale and under the account Inventory Stock on Hand.
  - The policies and procedures to properly identify excess inventory.
  - The policies and procedures to monitor and account for DLA-owned inventory sent for repair.
  - The policies and procedures that describe how inventory items are identified for reclassification into Inventory Manufacturing & Fabrication.
  - The policies and procedures to review inventory items in suspended inventory condition codes and to evaluate whether the inventory items should remain in the suspended condition code (based on the length of time in the suspended codes).
  - The policies and procedures to describe how long inventory should be stored at a distribution center once placed into a suspended condition code.
  - The policies and procedures to tie out the general ledger balances to the condition code reports used in the reclassification process.
  - The policies and procedures to reconcile inventory adjustments recorded during the reclassification process.
- Design policies and procedures in place to ensure that proper evidential matter exists to support inventory transactions related to the Aerospace inventory. Additionally, DLA should have policies and procedures in place that include a process to verify the inventory

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balances.

- DLA's policies and procedures related to supporting inventory transactions occurred and are accurately recorded in the financial statements should be updated to include:
  - Policies and procedures to ensure evidential matter is maintained to support inventory balances
  - Policies and procedures to standardize data elements included in data extracts from APSRs and EBS
  - Policies and procedures to standardize evidential matter required to support financial events
- Design policies and procedures to review inputs to the EBS MAP calculation to ensure that all appropriate costs are included. If costs are excluded, DLA should document the basis for determination and rationale for exclusion from the capitalized inventory cost, including the analysis of materiality.
- Design policies, procedures, and controls to ensure that analyses or validations of data are documented and conclusions reached are supported by sufficient evidential matter.
- Perform and document a subsequent analysis of all FMD sites and data impacted by the implementation of FMD 9.0 to determine if erroneous transactions remain in the data populations.

II. Property, Plant and Equipment

Property, plant, and equipment (PP&E) comprises real property, general equipment, internal use software, and construction-in-progress (CIP). In this audit of DLA, we found that DLA was not able to adequately support the existence, completeness, rights and obligations, or valuation of its PP&E.

DLA lacks policies and procedures to properly identify, account for and report real property where DLA is the financial reporting organization (FRO):

- DLA reports real property assets for which DLA is not able to demonstrate that DLA has rights to the asset. The FRO is the entity that has the primary economic benefit and is responsible for programming, budgeting, and executing the sustainment requirements. The FRO is the entity that reports the PP&E in their financial statements. DLA is unable to substantiate that DLA is the FRO for real property assets recorded in the balance sheet and related note disclosure. Supporting documentation, such as lease agreements, memorandum of agreement, or memorandum of understanding, is not available to substantiate that DLA is the FRO, as defined by the Department of Defense

DLA lacks policies, procedures and controls to verify the existence and completeness of real property and internal use software (IUS) due to:

- A physical inventory for real property was initiated in FY 2018. However, the results of these procedures were not finalized in FY 2018. DLA is revising its policies and procedures for performing the physical inventory of real property on an ongoing basis.

- DLA does not have documented policies and procedures in place to perform an inventory of IUS assets on a consistent basis. Unlike performing an inventory of physical assets, the existence of IUS is validated by verifying that the software functionalities and/or objects are still in use. DLA policy requires that the inventory is performed on 10% of the population each month. However, DLA does not comply with the policy.
- DLA has not designed adequate internal controls to identify when assets are completed and should be placed in service. DLA policy states that IUS assets are recorded as in-service PP&E upon the completion of the asset. However, DLA does not have a process in place to ensure that completed assets are placed in service in the correct period.

DLA lacks policies and procedures to review the construction-in-progress (CIP) balance and reconcile CIP to assets placed in service due to:

- DLA does not have documented policies and procedures in place to properly account for the CIP in the balance sheet. This includes policies and procedures to prevent or detect completed assets that may be inappropriately presented as active CIP and prevent or detect CIP assets that may be recorded in both CIP and real property, resulting in duplicate assets being recorded.

DLA is unable to substantiate the existence and completeness of real property assets, such as buildings, linear structures (above and below ground pipelines, bridges, roads, sidewalks, parking lots, etc.), etc., and general equipment assets, such as tank gauging systems, heavy machinery, etc., due to:

- DLA is unable to support the existence and completeness of real property assets.
- DLA is unable to provide evidence to substantiate the quantity of the linear structures recorded in its financial systems. DLA policy states that the unit of measure of linear structures include square foot, square yard, statute mile, etc. However, DLA is unable to substantiate the values used for the linear structures.
- DLA is unable to support the existence and completeness of general equipment assets. In addition, DLA was unable to substantiate whether assets were properly included or excluded.

DLA is unable to substantiate PP&E transactions, such as PP&E added or disposed of, during the fiscal year due to:

- DLA is unable to provide a complete and accurate population of additions and disposals. The listing did not reconcile to the activity in the financial statements.
- DLA is unable to completely and accurately substantiate the PP&E transactions recorded in EBS. The listing included a significant number of activity that were not valid additions and disposals. DLA was unable to differentiate the valid PP&E transactions in the listing.

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DLA lacks policies and procedures and related supporting documentation to properly value real property and general equipment in accordance with FASAB SFFAS No. 50, *Establishing Opening Balances for General Property, Plant, and Equipment* (SFFAS 50) due to:

- DLA was unable to demonstrate that the policies and procedures to value PP&E complied with SFFAS No. 50. The valuation methodology used to assign values to PP&E was not documented.
- DLA was unable to substantiate the values assigned to its PP&E assets, including substantiating that the application of SFFAS No. 50 was consistent and appropriate. The documentation was not sufficient to substantiate how the valuation methods were applied to each asset.

DLA was unable to substantiate values assigned to IUS assets are in accordance with FASAB SFFAS No. 10, *Accounting for Internal Use Software,* due to:

- DLA was unable to substantiate the values assigned to a significant amount of the IUS beginning balance. The documentation was not retained or available to determine whether the values recorded were in accordance with SFFAS No. 10.
- DLA was unable to substantiate the in-service date of the IUS assets, which is the basis for the asset amortization. The documentation, such as the evidence demonstrating that the asset was tested and accepted, is not retained or available.

DLA was unable to substantiate the values recorded for real property and general equipment in the financial statements:

- Placeholder values were used for a significant number of real property and general equipment assets resulting in misstatements in the financial statements (i.e. the asset and accumulated depreciation values).
- The valuation procedures for a significant number of real property and general equipment assets have not been completed. To account for these assets, DLA assigned placeholder values to these assets until the valuation process is completed.

DLA has not appropriately designed controls to adequately detect material misstatements in the financial statements:

- DLA has not designed and implemented sufficiently precise management review controls, including outlining the specific procedure required to evidence that the controls were performed. DLA's control activities include a significant number of management review controls. Management review controls are normally designed to detect and correct errors, whereby the reviewer determines whether information is complete and accurate, accounting is appropriate, and potential errors or misstatements. The control activities over PP&E are not sufficiently designed to prevent or detect material misstatements in the financial statements.

DLA lacks policies and procedures to ensure that similar assets are recorded on a consistent basis due to:

- Inconsistencies in the application of the accounting policies does not allow for DLA to ensure that all assets have been properly accounted for and recorded in the financial systems.
- DLA includes equipment, such as generators, with other assets, such as a building, in many instances. However, there are other instances where similar generators are recorded as unique assets.

DLA lacks policies and procedures to identify and assess lease arrangements and to properly account for lease obligations and disclose lease commitments, in accordance with FASAB SFFAS No. 5, *Accounting for Liabilities of the Government; Capital Leases,* and SFFAS No. 6, *Accounting for Property, Plant, and Equipment*:

- DLA has not completed procedures to identify all of its leasing arrangements, including assessing whether the leasing arrangements should be accounted for as a capital or operating lease.
- The financial statements do not include disclosures for its policy to account for lease arrangement, any operating lease commitments, and future minimum payments due.

DLA lacks policies and procedures to reconcile the PP&E note disclosure in the financial statements to the underlying financial systems:

- DLA does not have controls in place to reconcile the PP&E note disclosure in the financial statements to the accountable property system of record (APSR).

Recommendations

EY recommends that DLA consider the following corrective actions related to the deficiencies identified above:

- Develop documentation to substantiate that they are the FRO for the real property assets being recorded in the financial statements. DLA should work with the military services to obtain documentation, such as a lease, a memorandum of agreement (MOA), or memorandum of understanding (MOU), for all of their assets that confirms DLA's financial responsibility of the assets.
- Complete the physical inventory of real property to verify the existence and completion of the accounting records. The procedures should include:
  - Determining a sufficient and reasonable number of locations to perform the physical inventory.
  - Confirming 100% of the assets for any location tested instead of selecting a sample from each location.

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  - Verifying that the real property assets recorded exist.
  - Verifying that DLA is the FRO for all of its real property assets recorded.
- Update the IUS process memos and standard operating procedures to adequately describe the policies and procedures in place to inventory IUS assets.
- Design and implement policies and procedures to include the following:
  - Review the CIP balance on a periodic basis (i.e. monthly or quarterly).
  - Verify the accuracy of the listing of its CIP projects
  - Ensure that all projects included in the balance are active construction projects.
- Design and implement adequate policies and procedures to ensure that all of DLA's general equipment assets are recorded accurately and completely. Specifically, this should include a comprehensive inventory of general equipment assets that includes verifying the completeness of the listing of general equipment assets and verifying that the general equipment assets recorded exist.
- Design and implement policies and procedures that ensure the IUS assets are recorded in the appropriate period. This includes reviewing a complete and accurate list of all projects that have successfully completed end user testing and verifying that the projects have been recorded in EBS as active IUS assets.
- Add a data element in EBS - Financial Accounting (FI) Module to adequately differentiate between assets that have been added to or removed from the capital PP&E population and assets that have changed, or assign a unique identifier to each asset to allow a reconciliation to be performed to identify additions and disposals. For example, if the real property unique identifier (RPUID) value, which is a standard code used to uniquely identify DoD RP assets, was added to all asset records in EBS-FI, it would provide the ability to differentiate between assets that had been added to or removed from the capital PP&E population and assets that have changed. Since RPUIDs are assigned by the military services, if an RPUID has not been assigned, DLA could assign a temporary RPUID with a distinctive number pattern to make it easily identifiable as having a temporary RPUID.
- Design and implement policies and procedures concerning the performance of alternate valuation procedures for its real property. These should include the following components, at a minimum:
  - The process used to complete the plant replacement value (PRV) process,
  - How the facility (FAC) code is selected for each asset,
  - Ensuring that the correct cost factors were used,
  - How the value was calculated, and
  - Adequate review was performed of the documentation package to ensure the process was performed completely and accurately and is sufficiently supported.
- Design and implement policies and procedures to verify that all of DLA's general equipment assets are valued appropriately and the values assigned to all general equipment assets are substantiated by supporting documentation.
- Document the alternate valuation methodology for general equipment.
- Design and implement policies and procedures to ensure that DLA retains adequate supporting documentation to substantiate the values assigned to each asset. At a minimum, the documentation required should include how the value was determined, such as a price

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list or catalogue excerpt.

- Assign value to all general equipment assets using the alternate valuation method for which DLA does not have evidence of the historical cost.
- Adopt a policy to prospectively capitalize IUS assets, as described in Statement of Federal Financial Accounting Standards No 50, *Establishing Opening Balances for General Property, Plant, and Equipment (SFFAS No. 50)*. SFFAS No. 50 permits the exclusion of IUS and IUS under development from the opening balance as of the opening balance date.
    - Design and implement policies and procedures to ensure that DLA maintains sufficient supporting documentation to demonstrate that its IUS expenditures are appropriately capitalized, in accordance with SFFAS No. 10.
- Perform and complete the alternate valuation procedures in accordance with SFFAS No. 50 for all assets recorded in EBS for which historical costs cannot be determined.
    - Ensure that DLA has adequately documented the methodology used to perform these alternate valuations.
    - Ensure that DLA maintains adequate documentation to substantiate the value assigned for each asset valued using alternate valuation procedure.
    - Design and implement policies and procedures to ensure that the performance of review controls are adequately documented and supported by evidential matter.
    - Develop a central repository to retain evidence of control performance and management review.
    - Design and implement policies and procedures that include variance thresholds to ensure that the review of significant financial data is precise.
    - Design and implement policies and procedures that detail the related documentation and evidential matter to be inspected as part of the review.
- Develop and implement policies and procedures outlining how PP&E assets are recorded in the financial system to ensure that similar assets are accounted for consistently.
- Perform an analysis of assets recorded in EBS to determine completeness and accuracy of transitions recorded. Update the records in EBS as necessary prior to preparation of the financial statements.
- If time constraints prevent DLA from updating the value for each real property asset in EBS prior to the issuance of its financial statements, then DLA should prepare a reconciliation showing the adjustment to the value of each asset that has been made so that the total value of the adjusted real property assets in EBS agrees to the amount reported for real property in the corresponding footnote.
- Design and implement, as a part of the Manager's Internal Control Program (MICP), a key control to reconcile general ledger detail to the financial statements and related footnotes.
- Complete analysis of their leases to determine if DLA has entered into any leasing arrangements that should be accounted for and reported as a capital lease.
    - Design and implement policies and procedures to identify and account for leasing arrangements including whether the leases should be accounted for and reported as capital or operating leases, in accordance with SFFAS No. 6.
    - Develop policies and procedures to review all leasing arrangements to gather the information necessary to prepare and include the required disclosures for capital

and operating leases in the financial statements, in accordance with OMB A-136.

- Consider the impact that SFFAS No. 54, *Leases: An Amendment of Statement of Federal Financial Accounting Standards (SFFAS) 5, Accounting for Liabilities of the Federal Government, and SFFAS 6, Accounting for Property, Plant, and Equipment* will have on these policies when the guidance goes into effect.

III. Fund Balance with Treasury

Fund Balance with Treasury (FBwT) represents the aggregate amount of funds in DLA's account with Treasury. Through our audit procedures, we identified deficiencies related to DLA's processes of recording and reconciling transactions involving Fund Balance with Treasury.

DLA is unable to reconcile FBwT from general ledger directly to the U.S. Treasury:

- DLA, in conjunction with DFAS, has implemented the Cash Management Reconciliation (CMR) and Department 97 Report Reconciliation Tool (DRRT) processes as mechanisms to attempt to tie EBS to the Treasury. However, the CMR and DRRT processes are not sufficient to produce a complete and accurate reconciliation of DLA's general ledger to U.S. Treasury. There are known differences between CMR and Treasury.
- DLA is unable to substantiate beginning balances at the limit level for FBwT.
- DLA lacks policies and procedures to research and resolve differences between Treasury, disbursing system records, and accounting system records within a timely basis. The DRRT report contains transactions that are aged over 60 days, including transactions that are aged over 3 years.

DLA lacks sufficient policies, procedures and controls around the end-to-end FBwT process:

- DLA, in conjunction with DFAS, does not have controls to identify FBwT transactions related to DLA and to determine the amounts recorded in suspense accounts. As of June 2018, which is the only data available as of the date of the report, there were currently $6.5 billion of transactions recorded in suspense across the Department of Defense. DLA, in conjunction with DFAS, is unable to identify which transactions belong to DLA.
- DLA has not finalized the FBwT process narrative or systems flow to document the flow of data through DLA and DFAS systems from the initiation of a transaction to reporting in the financial statements, the key stakeholders within the process, or the flow of data between stakeholders. Additionally, DLA has not identified risks and controls for the end-to- end FBwT process.

DLA does not have policies and procedures to properly account for or monitor cash and cash balances due to:

- DLA lacks policies and procedures to ensure that cash is recorded upon receipt in accordance with SFFAS No.7, *Accounting for Revenue and Other Financing Sources.*

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Interfund transactions are not processed by Treasury until month-end reporting; however, DLA records the cash collection transaction in EBS on a weekly basis or prior to when the transactions occur.

- DLA lacks policies and procedures to properly review cash balances throughout the year to prepare cash projections and determine if DLA has enough cash to meet financial obligations. In previous fiscal years, the Department of Defense rescinded unobligated balances from the DLA Working Capital Fund. However, DLA did not consider how the rescission would impact their operations, including the ability to pay obligations, in the future.

Recommendations

EY recommends that DLA consider the following corrective actions related to the conditions described above:

- Work with DFAS to obtain a system and organization controls report for the CMR performed by the Defense Finance Accounting Service in order to obtain assurance on whether the CMR process is complete and accurate.
- Work with DFAS to obtain a system and organization controls report for the DRRT process performed by the Defense Finance Accounting Service - Columbus in order to determine whether the controls in place are operating effectively.
- Work with DFAS to establish a process, including a key control, for DLA to monitor the status of significantly aged unreconciled transactions in both the CMR and DRRT processes on a frequent basis.
- Design and implement an internal control procedure to reconcile the transactions recorded in EBS to the transactions sent to Secure Payment System (SPS) in order to verify that the data was processed correctly.
- Work with DFAS to create an updated policy and procedure for the DRRT process that addresses issues of maintaining sufficient evidential matter to support ongoing remediation efforts on undistributed transactions.
- Develop policies and procedures to establish DLA's involvement in monitoring undistributed funds and assisting DFAS with the research and the clearing process.
- Assign an FBwT point of contact for DLA in order to assist in communications that relate to FBwT, such as the DRRT process.
- Work with DFAS to implement a deadline for resolving errors identified as part of the performance of key control (KC) 45 from the FBwT PCM and maintain documentation of the research performed to resolve the error.
- Work with DFAS to ensure processes are in place to assign, track, age, research, and resolve differences between Treasury, disbursing system records, and accounting system records, as prescribed by Treasury, at the voucher level detail on a monthly basis and clear all differences within 60 days, with the exception of budget clearing account differences that have been identified by Treasury as exempt from the 60-day requirement.
- Finalize a standard operating procedure or process cycle narrative that documents the end-

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to-end process for FBwT, including the initiation, recording, processing, and reporting of FBwT transactions

- Finalize a standard operating procedure or process cycle narrative that documents the policies and procedures that the Defense Logistics Agency has in place to monitor the CMR and DDRT produced by the Defense Finance and Accounting Services. The standard operating procedure or process cycle narrative should include all key controls, process owners, data interfaces and Federal regulations followed. Additionally, it should include a complete list of all input documents, applicable systems, and system-generated reports used for the FBwT process.
- Designate a DLA point of contact responsible for overseeing the FBwT process, understanding the complex process flow and key risk points, as well as communication with DFAS.
- Establish frequent communication between DLA, in conjunction with DFAS, to accurately understand the processes that are performed at each agency in order to create a comprehensive and cohesive FBwT PCM that accurately reflects the procedures, policies, and internal controls.
- Develop a comprehensive risk assessment of the FBwT process that encompasses the risks and the policies and procedures that are performed by DLA, in conjunction with DFAS, which are responsive to the risk and perform procedures to verify that the information in the risk assessment is accurate.
- Establish internal controls that prevent further processing of the Treasury Tape until the Treasury Reporting Branch Interfund Accountant's supervisor reviews manually changed limits on interfund bills.
- Establish controls requiring the review of the Treasury Reporting Operations Accountant's reconciliation before submission of the Treasury Tape.
- Establish policies that require for variances to be resolved before submission of the Treasury Tape and establish policies and procedures to address the suspense account transactions within a reasonable time frame to prevent a misstatement.
- Configure EBS to reflect a debit to cash and a credit to accounts receivable when the cash transaction has occurred and cash has been received at US Treasury.
- Develop policies, procedures, and internal controls to identify and correct Defense Automatic Addressing System (DAAS) rejects timely to ensure that transactions are recorded completely and accurately in the financial statements.
- Develop policies and procedures to perform the following:
  - Review the information that is updated and changed by the DFAS accountant in the DAAS Reject Report.
  - Verify that the information changed for the DAAS reject is reflected in EBS.
  - Verify that the information is reflected in the file that Treasury receives to process the bills.
- Perform regular and recurring reconciliations of the suspense account data and remediate any deficiencies that impact the accuracy of the balances.
- Develop an estimate using relevant, sufficient, and reliable information to record the consolidated other defense organization (ODO) suspense account balances on the

individual ODOs' financial statements.

- Develop policies, procedures, and internal controls to assist in the research and identification of transactions recorded in suspense to assign them to the appropriate agency and to DLA.
- Evaluate current processes for determining that DLA has sufficient cash-on-hand to meet current financial obligations.
    - Implement policies and procedures to ensure a review control is in place to perform cash review on a frequent basis.
    - Document policies and procedures to follow if low cash balances are identified and detailed steps to address identified cash issues.
    - Outline required supporting documentation and maintain as part of the review process.

IV. Accounts Receivable

Accounts receivable (AR) consists of amounts owed to DLA and falls within the scope of DLA's order to cash process. Because of the nature of their services, DLA has a significant volume of transactions in the order to cash process. This balance represents a substantial portion of Working Capital Fund (WCF) activity that involves receipt of funds by DLA in order to provide inventory to their ultimate consumers. The volume of these transactions makes it a critical function for DLA to properly record and reconcile these transactions to assure timely, appropriate recognition of costs to the end users.

DLA lacks policies and procedures to properly identify valid unfilled customer order (UCO) transactions in EBS:

- DLA is unable to provide the supporting UCO detail that reconciles to EBS. As of July 2018, there were unreconciled variances totaling approximately $505 million. Further, DLA was unable to provide documentation to support the activity in EBS.
- DLA is unable to substantiate the existence and completeness of UCO transactions in EBS due to an interface error between the module and EBS. Additionally, DLA does not have sufficient policies and procedures in place to identify, research, and resolve unreconciled amounts.
- Policies and procedures are not in place to review the validity of significantly aged UCOs. Policies and procedures are not in place to ensure that inconsistencies in UCOs are identified and reviewed and dated orders are investigated.
- DLA does not have policies and procedures in place to identify and validate significantly aged UCO transactions balances that have been transferred from legacy systems into EBS.

DLA lacks policies and procedures to properly verify the existence of receivables:

- DLA is unable to trace customer payments to outstanding receivables. Detailed transaction data in EBS is unable to be matched to the activity in the Fund Balance with Treasury to substantiate the existence of the receivable.

- Receivables includes a significant amount of aged receivables (greater than 180 days). Policies and procedures are not in place to evaluate the collectability and payment authorization for significantly aged accounts receivable. DLA does not review aged receivables sufficiently for management to assert that the receivable exists.
- DLA does not have policies and procedures to review, reconcile, or clear negative accounts receivable balances in a consistent manner.
- DLA does not have policies and procedures to identify and validate significantly aged AR transactions balances that have been transferred from legacy systems into EBS.

DLA is unable to provide supporting documentation to substantiate the federal (intragovernmental) and non-federal (public) accounts receivable balances due to:

- DLA is unable to determine a complete and accurate listing of intragovernmental and public accounts receivable to properly present accounts receivable in the financial statements.

DLA lacks policies and procedures to account for the allowance for doubtful accounts due to:

- DLA does not have sufficient written policies and procedures that document their process for the calculation and posting of the allowance for doubtful accounts.
- DLA has not identified controls over the process to account for the allowance for doubtful accounts.

DLA lacks policies, procedures and controls to properly account for and report financial transactions during emergency management situations and disaster relief efforts:

- DLA did not accurately record payments received in advance in the financial statements.
- DLA did not accurately record revenue for goods and services provided for disaster relief in the financial statements.
- DLA is unable to provide a complete and accurate listing of sales transactions related to emergency management situations and disaster relief efforts.
- DLA does not have policies and procedures that documents the proper accounting treatment for cash advances received and sales transactions related to emergency management situations and disaster relief efforts.

DLA is unable to substantiate the occurrence and completeness of sales transactions due to:

- DLA is unable to provide supporting documentation that can substantiate revenue recorded occurred and is complete. Supporting documentation consists of screen shots from EBS and other internal financial systems that do not evidence that the sales transaction occurred with a third-party.

DLA is unable to substantiate the existence and completeness accounts receivable balances due to:

- DLA is unable to reconcile differences ranging from $25 thousand to $13.8 million between the accounts receivable balances recorded and accounts receivable balances confirmed by third parties.
- DLA is unable to provide supporting documentation to substantiate the existence and completeness of accounts receivable balances.
- DLA does not have adequate controls to record collections from customers accurately and timely, resulting in misstatements accounts receivable balances.
- DLA does not have policies and procedures that prevents multiple customers from being recorded in a single Department of Defense Activity Address Code (DoDAAC). As a result, DLA is unable to identify the customers included in certain accounts receivable balances.
- DLA is unable to provide accurate customer statements in a timely manner.

DLA lacks policies and procedures to properly record sales and receivable transactions in the correct accounting period due to:

- A significant number of transactions were unable to be posted in the correct accounting period.

DLA does not have controls in place to reconcile postings and tie points between budgetary and proprietary transaction level detail:

- DLA has posting logic errors in EBS and its feeder systems, causing budgetary and proprietary accounts to not reconcile at the detail level.

Recommendations

EY recommends that DLA consider the following corrective actions related to the deficiencies identified above:

- Continue to investigate and attempt to resolve the legacy posting differences between the EBS general ledger and the EBS Sales and Distribution (S&D) module. Create standard operating procedures for the reconciliation of the EBS trial balance and EBS S&D module and associated adjusting journal voucher (JV) to ensure properly designed reconciliations are performed in a timely manner.
- Establish and implement the policies and procedures to review the aging of UCO balances. DLA should perform and document procedures to assess the validity of the UCO balances. This assessment should include the DLA's policies regarding cancelling invalid orders, management's key assumptions regarding UCOs, and an evaluation of the reasonableness of these key assumptions.
- Implement a process to review the DLA's aged transactions throughout the order to cash

process to validate that the population of transactions within EBS is valid and complete. Perform a data cleanse of EBS to remove any data that is incorrect, incomplete, improperly formatted or duplicated.

- Develop policies and procedures to perform detailed reconciliations of large, ongoing customer balances for both federal and public account holders. The reconciliation should include beginning balance, period sales, period collections, credits and returns, and adjustments, with an ending balance tied to the quarterly AR aging. Attempt to push forward a coordinated DoD process to manage and exchange detail level exchange data for TI-97 collections. Attempt to push forward an expanded coding structure in order for all other defense organizations ("ODOs") each have their own unique identifying code in Fund Balance with Treasury transaction detail.
- Establish and implement policies and procedures to adequately review aged intragovernmental receivables, including assessing collectability. DLA should consider (a) the age of the receivable, (b) the federal agency's payment history, (c) the federal agency's ability to pay using appropriated monies, and (d) the probable recovery amounts relating to the federal agency. Establish and implement a policy that when DLA has determined it is more likely than not (greater than 50%) these intragovernmental receivables will not be totally collected, the gross amount of their intragovernmental receivables should be reduced to its net realizable value and record a corresponding loss due to uncollectible amounts.
- Analyze current controls in the order to cash process as a part of DLA's Manager's Internal Control Program (MICP). Perform an analysis of the current negative receivable balances to validate and correct negative receivable balances, as needed. Implement additional internal controls that entails DLA management performing a periodic review of negative customer account balances for each major revenue stream in the Working Capital Fund.
- Perform an assessment of the end-to-end process to ensure all key functions are documented. Update standard operating procedures or process cycle memoranda to document the policies and procedures DLA has in place to monitor their negative receivable balances. The standard operating procedure or process cycle memorandum should include all key controls, process owners, data interfaces and the applicable guidance followed. Additionally, it should include a complete list of all input documents, applicable systems, and system-generated reports used in the process. DLA should develop and maintain documentation evidencing management's review of negative receivables.
- Analyze current controls in the Disposition Services sales program as a part of DLA's MICP. Analyze and update the current controls in place for the shipping and acknowledgement by the customer of order receipt. Analyze and update the current controls in place for the accurate tracking and posting of credits and expense reimbursements for customer accounts. DLA should review and correct the customer balance as outlined in the condition.
- Analyze the significantly aged receivables included in the AR Aging Report and consider the validity and existence of these receivables. Perform management review controls to validate customer receivable balances are complete and accurate, including review over the collections received from customers. Perform management review controls over

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DLA's AR aging report and validate that customer accounts represent a single customer, rather than a group of customers.

- Implement a process to review the assignment of "Dunning" codes as part of DLA's customer management policies to validate the completeness and accuracy of the federal versus public outstanding accounts receivable as presented on DLA's financial statements.
- Develop and maintain internal control documentation relating to the WCF non-federal AR allowance estimation process. The documentation should include the initiation of the estimate, the recording and processing of the estimate, and the reporting of the loss to the general ledger. Additionally, the documentation should include the journal entries recorded throughout the WCF allowance process. DLA's management should consider including documentation relating to the following:
    - The financial statement risks relating to the process
    - General ledger accounts relating to the process
    - Key controls relating to the process, including management's review of the allowance estimate
    - Control type, frequency and specific process owners relating to these key controls
    - Identification of information systems relating to these key controls
- Additionally, DLA's documentation of these key controls relating to the collectability of their non-federal receivables should include consideration of the following:
    - The age of the receivables, understanding the entity's customary terms of sales, the conditions under which goods may be returned and how collections and credit memos are applied to outstanding balances
    - The soundness of DLA's credit granting and collection procedures, including any of DLA's credit limits
    - Collection experience subsequent to the balance sheet date
    - Historical bad debt experience
    - Comparative statistics for the current period and prior periods, such as the relationships of accounts written off and the allowance and provision for doubtful accounts to trade receivables and sales
    - Conditions and trends in the industry and the economy in general
- Develop policies, procedures, and controls around financial reporting requirements during emergency management situations, including disaster relief efforts. Ensure these policies include acceptable deviations from the normal business process, documentation requirements, and timelines for completion.
- Perform an analysis of transactions posted in the general ledger in FY18 related to the disaster relief efforts and ensure amounts are recorded in the appropriate period.
- Perform procedures to validate the completeness and accuracy over sales populations relating to sales to Federal Emergency Management Agency (FEMA). Document procedures performed to validate the completeness and accuracy of data used in DLA's monthly JV relating to the FEMA disaster relief efforts. Coordinate the posting of advance payments in a timely manner in order to properly record advances and sales amounts earned against the advances into EBS.
- Develop a process to timely produce supporting evidential matter for revenue transactions,

including, but not limited to, sales invoices, shipping documents, contracts, material acknowledgement receipts, and other supporting evidence. Evaluate current policies and procedures against practices within DLA to identify the root cause(s) of conditions. Identify key gaps and inconsistencies in current procedures versus field implementation. Based on the evaluation, perform updates to identified policies, procedures, desk guides, and/or accounting manuals to completely and accurately reflect current key processes as well as provide clarification/updates to areas where differences between policy and implementation are noted.

- Provide trainings and implementation guidance on any current and/or new/updated procedures where issues were noted to ensure consistent application of procedures. Increase communication between DLA headquarters and process owners to ensure sufficient, complete documentation is provided as part of documentation requests. After processes have been evaluated and procedures have been updated, as needed, implement and/or strengthen review procedures to ensure key controls are being performed and that there is evidence of the controls. DLA should evaluate individual issues identified in the condition above and perform corrective action, as needed, to ensure identified samples have required supporting documentation.
- Implement processes and procedures to manage and maintain evidential matter relating to DLA's AR and sales transactions. DLA should maintain and manage supporting evidential matter in a way allowing for the documentation to be readily available for examination. DLA should maintain and manage sufficient detailed customer statements to adequately substantiate the AR balances recorded.
- Implement a process to manage and maintain evidential matter relating to DLA's sales transactions. DLA should maintain and manage supporting evidential matter in a way allowing for the documentation to be readily available for examination. Extend the close time within EBS and implement additional policies and procedures for monitoring of sales transactions at year-end.
- Analyze and investigate the known budgetary to proprietary tie point variances related to AR and revenue at a business process level to determine the root cause. DLA should assess their current policies and procedures around the budgetary to proprietary reconciliations including the design of key controls in the process. DLA should design a control that focuses on addressing the root cause of the variances in order to resolves current underlying issues as well as prevent future variances from occurring.

V. Accounts Payable

Accounts payable (AP) consists of amounts owed to vendors and falls within the scope of DLA's procure to pay process. Because of the nature of the services, DLA has a significant volume of transactions to procure goods and services to sell to its customers. Through our audit procedures, we identified deficiencies in DLA's processes for recording and supporting accounts payable and the related budgetary balances; recording transactions in the proper period; documenting policies, procedures, and controls in a sufficient manner; and designing and executing controls over the processes to create and approve obligations and to review, record and pay invoices.

DLA is unable to adequately support the accounts payable and related budgetary balances:

- DLA does not have policies and procedures to ensure shipment costs submitted by a vendor managed inventory (VMI) contractor is complete, proper, and accurate.
- DLA is unable to substantiate accounts payable and undelivered orders:
  - Supporting documentation was not provided or provided in a timely manner to substantiate the samples tested from the following accounts:
    - Accounts payable
    - Negative payables
    - Undelivered orders, unpaid
    - Undelivered orders, paid
    - Upward/downward adjustments, undelivered orders
    - Downward adjustments, delivered orders
  - Goods and/or services received as of year-end were not recorded as an expense/asset and not applied to the undelivered order balance.
- DLA is unable to demonstrate obligations were approved by an authorized official or were approved before the contract was awarded, and is unable to substantiate the validity of recorded good receipts.
- DLA does not record upward/downward adjustments timely and in the correct period

DLA does not have policies and procedures to record obligations and liabilities incurred accurately and in the proper period:

- DLA records obligations and liabilities incurred in the incorrect period.
- DLA does not have adequate controls to ensure outbound Military Interdepartmental Purchase Request (MIPR) obligations are created within Enterprise Business System (EBS) in a timely manner.
- DLA does not have adequate controls to ensure that contracts are appropriately executed. As a result of contracts being executed incorrectly, DLA did not record the obligation at the time of the contract award.
- DLA does not have a complete and accurate accounts payable accrual policy for iRAPT transactions. DLA policy allows for a liability to be recorded without confirming whether a transfer of title has occurred or service has been rendered. Further, DLA policy requires that only activities submitted by the contractors on the last day of the month are accrued and liabilities incurred prior to the last day of the month are not accrued.
- DLA does not properly record the Mechanization of Contract Administration Services MOCAS accrual liability. DLA records the MOCAS accrual liability with corresponding entries to inventory accounts, regardless of whether the liability is related to inventory or service related procurement contracts. DLA is unable to determine the portion of the accrual that pertains to service contracts
- DLA does not record the accrual for material receipt acknowledgement transactions accurately. Revenue is earned at the same time that the liability is incurred for these types

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of transactions. However, DLA does not record the revenue earned at the same time the liability is recorded.

- DLA does not have an accurate methodology to account for the adjustment for negative payables. Further, the accounting policy is not in accordance with Treasury Financial Manual/USSGL. DLA's policy for accounting for negative payables is recorded using incorrect general ledger accounts. DLA uses an expense general ledger account to replace asset and budgetary general ledger accounts.
- DLA's does not have a complete and accurate accounts payable accrual policy for outbound MIPR transactions. DLA applied the straight-line method to calculate the accrual amount. DLA did not perform any assessment to determine whether this is an appropriate methodology. Particularly, for MIPRs that do not have a fixed monthly cost, the straight-line method is not appropriate. Rather, DLA should use the activity-base costing method to calculate the accrual amount.

DLA does not adhere to the Treasury Financial Manual USSGL posting logic:

- A general ledger account is inappropriately being used to track accounts payable activity. DLA uses negative payables to track outstanding goods receipt and to prevent inventory from showing as available for distribution when the items are not physically available. The related posting logic is not recording assets or expenses at the appropriate point in time. In addition, an undelivered order, paid is recorded for these transactions, but the proprietary entry for the payment made in advance is not recorded.
- DLA inappropriately expensed costs that should have been capitalized, resulting in a misstatement in the financial statements.

DLA does not comply with the Federal Financial Management Improvement Act due to the following:

- Transactions were not recorded at the detailed transaction level. DLA recorded transactions at a summary level for certain budgetary and proprietary accounts. As a result, each EBS summary level record contains multiple individual transactions.
  - Transactions are posted in detail to the Fund Balance with Treasury (FBwT) account, but summarized when posting to the other proprietary and budgetary accounts. A reconciliation is not performed to ensure that all detailed transactions posted to the FBwT agree to the summarized postings to the corresponding budgetary general ledger accounts.
  - Additionally, budgetary accounts (obligations, expenses, payables) are not tied to the FBwT transactions and are posted in summary within the general ledger.

DLA lacks policies, procedures, and controls in the accounts payable process, including the process to create and approve obligations, and the process to review, record, and pay invoices due to the following:

- DLA does not have adequate controls to ensure that the obligations and invoices were approved by an authorized official, and DLA was not able to retain the appropriate supporting documentation for obligations.
- DLA does not have adequate policies and procedures to ensure billing/invoices received by DLA are submitted to DFAS or policies and procedures to ensure DFAS records the billing/invoices into EBS in a timely manner.
- DLA does not have adequate controls to ensure that carrier invoices, which require manual approval, and summary invoices are appropriately reviewed prior to payment.
- DLA does not have adequate controls to ensure outbound MIPR good receipts are posted in a timely manner.
- DLA's controls for the proper approval of invoices; receiving reports; and purpose, time, and amount for the following accounts were not operating effectively: accounts payable, negative payables, and expense accounts.
- DLA's control for the government purchase card expenditure approval was not operating effectively because of the following:
    - The Approving/Billing Official (A/BO) has the ability to approve the monthly statement in US Bank Access Online and certify that statement for payment without any secondary review.
    - When the government purchase card holder (GPCH) is not available to reconcile purchase card transactions to the statement, the A/BO has the authority to perform the reconciliation and prepare the form 1901 (Request for Purchase).
    - The A/BO can approve the GPC monthly bill in U.S. Bank Online for payment.
- DLA does not have adequate controls to prevent improper payment of invoices.
- DLA does not have adequate controls to ensure MOCAS payments, which failed to post in EBS systematically, are posted in EBS in a timely manner.
- DLA does not have adequate policies and procedures to ensure interfund transactions are posted in EBS in a timely manner.
- DLA does not have adequate policies and procedures to ensure that invoices are paid in a timely manner and interest penalties paid for these late payments to mitigate the risk of noncompliance with the Prompt Payment Act.

DLA does not have effective internal controls to ensure that unliquidated orders (ULOs) are cleared in a timely manner:

- DLA does not have adequate controls to ensure invalid undelivered orders (UDOs) were closed in a timely manner. In our testing, we found purchase orders that were significantly aged, including a purchase order that was open for approximately five (5) years prior to being closed.
- DLA does not have effective controls to ensure ULOs are resolved in a timely manner. Specifically, DLA does not follow the ULO policies and procedures, as designed.
- DLA does not have policies and procedures in place to manage stale payables/obligations:
    - A timely review and monitoring is not performed for the following account

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balances:

- Negative payables – There is a significant number of aged transactions that may no longer be valid.
- Army Medical Materiel Agreement (AMMA) payables – Transactions are not properly cleared from the account resulting in transactions that are recorded in the account that have been paid and completed in prior years.
- Undelivered orders (UDO), unpaid – There is a significant volume of UDOs that had no activity.

Recommendations

EY recommends that DLA consider the following corrective actions related to the conditions described above:

- Evaluate current policies and procedures against practices in the field to identify the root cause of DLA not being able to provide sufficient, appropriate evidential matter related to accounts payable and undelivered orders samples. Identify key gaps and inconsistencies in current procedures versus field implementation.
- Based on the evaluation, perform updates to identified policies, procedures, desk guides, and/or accounting manuals to completely and accurately reflect current key procure to pay processes, as well as provide clarification/updates to areas where differences between policy and implementation are noted.
- Consider providing trainings and implementation guidance on any current and/or new/updated procedures where issues were noted to ensure consistent application of procedures, including:
    - Ensure procure to pay process owners document detailed explanation (i.e. cause, impact) for discrepancies or missing documentation.
    - Ensure documentation standards are clear including supporting documentation that is complete, accurate, and prepared timely.
    - Ensure process owners understand key supporting documentation.
- Consider increasing communication between DLA headquarters and process owners to ensure sufficient, complete documentation is provided as part of documentation requests.
- After processes have been evaluated and procedures have been updated, as needed, implement and/or strengthen review procedures to ensure transactions are recorded accurately, timely and process owners can obtain and provide supporting documentation for the transactions.
- Write off residual accounts payable for paid and completed transactions. EY recommends that DLA removes activity from the general ledger detail that were completed in prior years. DLA should monitor the UDO balances and identify stale UDOs for de-obligation. DLA should examine account balances on the balance sheet and statement of budgetary resources to determine the magnitude of aged balances by account.
- Perform an analysis of transactions posted at or near year-end to determine the overall significance of the issue across all general ledger accounts. Based on this analysis, perform

corrective action on incorrect transactions, as necessary.

- Implement and/or enhance DLA's year-end process, including key controls, for monitoring potential business events that will need to be entered into the general ledger prior to year-end close.
- Update policies and procedures to document year-end processes for identifying, monitoring and recording transactions prior to financial statement close.
- Discontinue the use of the negative payable account. In addition, DLA should develop, test, and implement a process to ensure that all transactions related to proper recording and reporting for expenses and inventory items are in compliance with the TFM USSGL postings at the transaction level. This would include developing an entity wide standard process and procedure of identifying the financial events that requires the recognition of an account payable based on standard accounting guidance (Ex. Treasury Financial Management Service [FMS] USSGL guidance - Recognition of a Liability). EY further recommends that once the new procedures are in place, stakeholders are educated on the new process. EY further recommends that any process, procedure, or policy documentation for accounts payable be updated to reflect the use of the asset or expense accounts instead of the negative payable accounts.
- Implement and maintain financial management systems that comply substantially with federal financial management systems requirements and the United States Government Standard General Ledger at the transaction level. DLA should establish a process that reconciles the transaction level detail to the summarized postings in each account.
- Update existing internal control documentation to accurately describe the procure to pay process and identify key internal controls over financial reporting.
- Monitor, review, and validate whether controls are operating effectively on an on-going basis related to the procure to pay process.
- Update existing internal control activities to produce evidence that the control occurred (e.g. signature) after the control is executed in the procure to pay process.
- Implement limiting the A/BO to one key role to either approving government purchase card (GPC) purchases on DLA form 1901 or approving payments of the GPC monthly bill in U.S. Bank Online. If DLA is unable to properly segregate the duties, DLA should require a secondary reviewer as a mitigating factor to approve the monthly bill or approving the form 1901.
- Perform a root-cause analysis to determine the risk areas and develop and implement the following:
  - Process narratives, policies and procedures to ensure goods receipts are recorded in EBS in a timely manner.
  - An accounts payable accrual methodology that adequately considers the nature of the liabilities incurred, the data used in determining the accrual balance is appropriate, periodic review to assess whether the established methodology is still valid.
  - Specific risks associated with the transportation invoice and summary invoice review process and implement controls to mitigate those risks based on Government Accountability Office's (GAO) internal control framework.

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- Controls to ensure interfund transactions are recorded in EBS appropriately and in a timely manner.
- Controls to review the population of indefinite quantity contracts (IQC) and determine whether other awarded IQC are properly classified, and review GAO's Redbook and Financial Acquisition Regulation and appropriately develop process narratives, policies, and procedures to address the issues identified.
- Controls to ensure ULO transactions are reviewed and resolved in a timely manner.
- Process narratives, policies and procedures to ensure obligations are created in a timely manner.
- Methodology that adequately captures the liability and expense balances and uses appropriate general ledger accounts to post each transaction either as an expense or an asset, data validation to ensure the data used in determining the accrual balance is appropriate, analysis to determine the adequacy of the methodology, and periodic review to assess whether the established methodology is still valid.
- Process narrative, policies and procedures to adequately capture liability incurred and revenue earned for transactions processes through the Medical Reconciliation Application (MRA) system, data validation to ensure the information used to calculate the accrual is appropriate, and analysis to determine the adequacy of the methodology.
- Controls to ensure payments processed in MOCAS are recorded in EBS appropriately and in a timely manner.
- Controls to enhance the invoice review process to ensure that the review procedures include reviewing source documents for shipment related costs.
- Accounting policies and procedures to ensure:
  - Liabilities are recorded in the period incurred and costs are accurately recorded.
  - Invoices are reviewed by authorized personnel.
  - Obligations are approved by authorized officials.
  - Appropriate supporting documentation for obligation is retained.
  - Compliance with current accounting standards.
- Process narratives, policies and procedures to ensure invoice receipts are recorded in EBS in a timely manner and to ensure sufficient oversight of the service organization.
- Process narratives, policies and procedures to ensure invoices are paid in a timely manner or interest penalty is paid when payments are made late.

- Develop an accounts payable accrual methodology that adequately considers the nature of the liabilities incurred, perform data validation to ensure the data used in determining the accrual balance is appropriate, and perform analysis to determine the adequacy of the methodology. Furthermore, DLA should perform periodic review to assess whether the established methodology is still valid. DLA should use the appropriate general ledger accounts to post each transaction either as an expense or an asset.
- Perform an analysis of transactions posted at or near year-end to determine the overall significance of cutoff issues related to upward/downward adjustments across all general

ledger accounts. Based on this analysis, perform corrective action on incorrect transactions, as necessary.

VI. Financial Reporting

Financial reporting encompasses all aspects of operations affecting DLA's ability to produce reliable financial statements and disclosures. This process starts with establishing an effective governance structure to identify and assess risk and continues with developing a control environment that is effective and efficient to manage identified risks. Through our audit procedures, we identified a number of deficiencies in DLA's processes related to the accumulation and presentation of their financial position and results of operations.

DLA does not have sufficient policies and procedures in place around the implementation and monitoring of the Enterprise Business Systems (EBS):

- DLA is unable to adequately demonstrate that business events are linked to the correct posting logic.
  - In DLA's posting logic reference book, which was manually generated, there are multiple scenarios associated with the same transaction description and SAP T-Code (i.e., EBS document type).
  - In DLA's posting logic reference book, there is no attribute or data field to indicate the type of transaction posting in EBS. Therefore, DLA is unable to crosswalk the reference book to the EBS.
  - DLA is unable to produce a posting logic directly from EBS.
- DLA does not have any monitoring or review controls in place to ensure that EBS posting logic is configured in accordance with the United States Standard General Ledger (USSGL).
- DLA has not completed mapping all funds centers used in EBS to, or restricted posting access to the fund centers by, the respective MSC.

DLA does not have sufficient controls in place to validate and monitor that EBS proprietary general ledger accounts agree to budgetary general ledger accounts:

- DLA has known reconciliation issues between budgetary and proprietary tie points. Based on walkthrough procedures performed, EY observed that the DFAS posts unsupported monthly and quarterly JVs in EBS and Defense Departmental Reporting System (DDRS) to ensure DLA's budgetary accounts reconcile to the proprietary accounts.
- DLA has known tie-point variances between proprietary and budgetary FBwT.
- DLA has known tie-point variances between proprietary and budgetary AR and revenue.

DLA does not have sufficient controls in place around the quarterly reconciliation of EBS to the financial statements:

- DLA does not perform a sufficient monthly or quarterly unadjusted trial balance (UTB) to adjusted trial balance (ATB) reconciliation.
  - DLA uses data pulled out of DDRS as a starting point for the reconciliation instead of using data directly pulled from EBS.
  - DLA lacks controls to validate the completeness and accuracy of the data and reports used to create the reconciliation.
  - Lack of a complete master listing of files used within the reconciliation, including the source system, parameters used to generate the report, and the purpose of each file.
  - Lack of a review to ensure that feeder files and adjustments are valid and agree to supporting documentation.
  - DLA lacks controls to verify that the crosswalk from EBS to DDRS is complete and accurate.
- DLA does not perform the quarterly UTB to ATB reconciliation in a timely manner.
  - DLA does not perform the reconciliation until after the quarter-end, as well as fiscal year-end, has been closed.
  - Per the standard operating procedures, DFAS should provide DLA the data files needed for the reconciliations five (5) days after quarter/year-end close. However, the reconciliations are completed approximately two months subsequent to quarter-close.

DLA does not perform a sufficient review of monthly or quarterly adjustments and JVs made by DLA and DFAS:

- DLA does not have a comprehensive listing or monitor the adjustments made within EBS to ensure that the adjustments and JVs are appropriate, supported, reviewed, and approved.
- DLA does not have a comprehensive listing of adjustments that occur in DDRS including:
  - The source of each file and parameters used to generate the JV logs/files.
  - The required files or reports needed from DFAS to support each adjustment as well as the parameters of each file or report.
  - The rationale or business purpose for each adjustment and the evidential matter to support the amounts.
- DLA does not review each type of adjustment and feeder files to determine completeness, accuracy, validity, and impact of information posted to DLA's financial statements.
  - In several cases, prior year adjustments were used in the reconciliation of the DDRS - Budgetary (DDRS-B) unadjusted trial balance (UTB) to the DDRS-B adjusted trial balance (ATB) that did not have evidence of review by DLA.
  - Trial balance input adjustments occurred during the interface of DDRS-B to DDRS - Audited Financial Statements (DDRS-AFS) that were not reviewed by DLA.
- DLA relies on DFAS to make various adjustments that are maintained within DDRS-B versus making the corrective update within EBS.
  - Within the quarterly reviews, prior year adjustments were used as offsetting entries to the current year adjustments.

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- DLA does not perform a reconciliation in a timely manner to allow for the adjustments to be reviewed prior to the generation of the financial statements.
- DLA has not completed the remediation of the trading partner elimination process, which was scheduled to be completed in FY 2018. EY noted the following during FY 2018:
    - Supporting documentation to reconcile the variances between DLA and trading partners is not obtained timely.
    - DLA relies on contractor maintained software tools to determine the balances for trading partners. There is no evidence that DLA assesses the completeness or accuracy of data input or output from this tool.
    - Adjustments made to accounts receivable, accounts payable, revenue, expenses, and undisbursed funds are not appropriately supported.
- DFAS performs quarterly elimination adjustments to DLA's financial statements for both waived and non-waived entities.
    - EY observed that there is not a complete reconciliation at the agreement level to the trading partner adjustments that are being made. Trading partner adjustments are recorded in DDRS-AFS as "top-side" adjustments and are identified as "unsupported" by DFAS.

During EY's review of the third quarter (Q3) FY18 and fourth quarter (Q4) FY18 financial statement and footnote disclosures, we determined that the level of review performed was insufficient to detect and correct misstatements in the financial statements and related disclosures:

- Inaccurate balances reported in the financial statements and notes.
    - Line items were not appropriately broken out between federal and non-federal.
    - Gross cost did not accurately foot on the statements.
    - Balances per the notes do not consistently agree to the balances on the statements.
    - In the property, plant and equipment (PP&E) footnote, the construction-in-progress (CIP) balance was incorrectly stated when DLA determined most of these projects to be inactive.
    - Supporting documentation did not adequately support the balances recorded in the notes.
    - DLA is unable to fully prepare financial statements in conformity with U.S. GAAP due to limitations of the financial and nonfinancial management systems and processes that currently support the financial statements and described in Note 1 Significant Accounting Policies.
    - DLA does not present comparative financial statements.
- Lack of complete and accurate disclosures.
    - Note 1 Significant Accounting Policies (SAP) did not completely and accurately summarize the accounting principles and methods of applying those principles.
    - Note 1 SAP did not appropriately disclose management's judgments relevant to valuation, recognition, and allocation of assets, liabilities, expenses, and revenues.
    - Note 1 SAP did not sufficiently describe changes or non-compliance in GAAP reporting

- DLA currently does not have policies and procedures providing an end-to-end process for identifying contingent legal liabilities

DLA does not have a process in place to validate budgetary beginning balances:

- DLA does not perform procedures to verify the accuracy of the beginning balance in General Ledger (GL) account 4201, Total Actual Resources Collected and GL Account 4139, Contract Authority Carried Forward.

Recommendations

EY recommends that DLA consider the following corrective actions related to the deficiencies identified above:

- Evaluate EBS posting logic and evidential matter to ensure system posting logic is configured in compliance with USSGL and DoD Standard Financial Information Structure (SFIS).
- Evaluate EBS system capabilities and provide a system-generated mapping report which ties EBS configured posting logic to EBS transaction codes, movement types, and USSGL/DoD transaction numbers
- Document clear descriptions of business events and varying circumstances that impact or change the posting logic.
- Document transaction descriptions based on the EBS doc type to identify the type of transactions within the EBS universe of transactions.
- Implement monitoring or review control to ensure EBS transactions are being posted as intended.
- Complete the mapping of EBS fund centers to MSCs.
- Update policies and procedures for assigning and managing fund centers in EBS.
- Analyze and investigate the known budgetary to proprietary tie point variances at a business process level to determine the root cause.
- Assess current policies and procedures around the budgetary to proprietary reconciliations including the design of key controls in the process. DLA should design a control that focuses on addressing the root cause of the variances in order to resolve current underlying issues as well as prevent future variances.
- Evaluate the current process for reconciling the UTB to the ATB:
    - Identify areas to create efficiencies through automating the process.
    - Consider other reconciliation options to design a reconciliation that is performed in conjunction with the production of the DDRS-AFS trial balance and not subsequent to the production.
    - Consider the design of the reconciliation and ensure that data is being pulled from the proper sources to ensure completeness and accuracy of data interfaces.
    - Consider documenting the list of reports generated by DFAS and the specific parameters used to generate the reports.

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- As a part of the MICP, assess the risks associated with the process to generate the financial statements including the complexity, extent of manual processes, decentralization, and reliance on third party data. Based on the assessed risks, determine if sufficient policies, procedures and controls are in place to address risks related to the compilation of the financial statements.
- Evaluate the current support agreement with DFAS to determine if agreement sufficiently documents roles, responsibilities, communications, and timelines needed to support DLA's reconciliation requirements.
- Evaluate the policies and procedures in place over the financial reporting process including the specific roles of DLA and DFAS related to journal vouchers, adjustments, and eliminations recorded by DFAS:
    - Document the list of reports generated by DFAS and the specific parameters used to generate the reports.
    - Include a control(s) for reviewing all the files that are used to adjust the ending balances within EBS in the creation of the adjusted trial balances.
    - Document the business need for adjustments and the appropriate evidential matter required to support adjustments.
- Evaluate current quarterly adjustments and prior year adjustments to determine if the adjustments recorded in DDRS-B could be eliminated by making the adjustments within EBS.
- Evaluate the quarterly trading partner adjustments and design controls and a process to perform a reconciliation at the agreement level.
- Implement additional controls for the agreement level reconciliations with DLA trading partners and develop a process for resolving variances at the agreement level in a timely manner.
    - Evaluate system capabilities to include recording and monitoring transactions at the trading partner and agreement level.
- Finalize updated policies and procedures for identifying, researching, and reconciling variances between DLA general ledger data and trading partners. Include considerations for:
    - Review of appropriate classification between federal and non-federal.
    - Review impact on both proprietary and budgetary general ledger accounts.
- Work with DFAS and Office of the Under Secretary of Defense as necessary to continue to resolve issues with trading partners at the department level.
- Evaluate all components of OMB-136 and recent accounting pronouncements and determine if disclosures are complete, accurate and compliant. Incorporate updates to footnotes as necessary.
- Re-assess review controls associated with the financial statement review process and consider including:
    - A review of revised OMB-136 requirements to ensure updated guidance is evaluated and incorporated in a timely manner.
    - Other reviews by business process areas to ensure disclosures are complete, accurate and compliant. These reviews should ensure that footnote disclosure are

consistent with business activity occurring throughout the year.
  - An assessment of current checklists used in the financial reporting process to determine if checklists need to include enhanced review procedures.
  - Design and document standard operating procedures to ensure that the beginning balance for carry forward budgetary accounts are accurately stated.
- Develop and implement internal controls, along with policies, procedures and end-to-end process cycle memorandums, as appropriate, to identify and estimate contingent liabilities related to litigation. In addition, DLA should include procedures to identify, assess and disclose unasserted claims

VII. Oversight and Monitoring

Oversight and monitoring relates to DLA's lack of establishment and implementation of a sufficient control environment, enterprise-wide.

DLA lacks a sufficient control environment related to internal controls over financial reporting, including a sufficient A-123 program:

- A sufficient risk assessment, performed at the appropriate level, related to reporting such as documenting the complexity of programs, accounting estimates, related party transactions, and extent of manual processes.
- An evaluation of fraud risks and the approach to implement financial and administrative control activities to mitigate identified material fraud risks.
- A finalized policy and procedure to develop and implement Enterprise Risk Management (ERM) and internal control, including anti-deficiency act reporting, that includes appropriate documentation requirements that are necessary as a part of an effective internal control system.

DLA lacks sufficient policies and procedures around financial and budgetary reporting, including:

- Sufficient written policies and procedures do not exist related to management review controls for the financial reporting process. The identified management review controls do not accurately describe the procedures performed to detect or correct an error.
- Policies or procedures are not in place to verify the accuracy and completeness of system generated reports used in the execution of controls.
- DLA's Funds Management policies and procedures documentation is incomplete and inaccurate.
  - The risks and related controls have not been completed identified and assessed in the budget to execute process.
  - Controls over the transfer process do not exist.
  - Controls over the Treasury warrant process do not exist.

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DLA does not perform sufficient oversight and monitoring of system and organization control reports:

- DLA has not associated each relevant complementary user entity controls (CUECs) to specific DLA controls.
- DLA has not identified specific DLA compensating controls for system and organization controls deemed ineffective in each applicable SOC 1 report.
- DLA has unresolved control gaps related both to addressing control issues identified in the SOC report as well as with DLA's CUECs.
- DLA's evaluation was not performed by the subject matter experts (SMEs) in a timely manner. As of the date of this report, the SMEs had not reviewed the evaluation and the controls identified as possible mitigating controls.

Recommendations

EY recommends that DLA consider the following corrective actions related to the conditions described above:

- Continue to design and implement DLA Statement of Assurance (SOA) policy at all levels throughout the organization and emphasize the importance of the Manager's Internal Control Program (MICP) from DLA leadership. This will help bring visibility, education and support to the program from across the organization.
- Ensure the DLA SOA policy includes proper detail and guidance for conducting the risk assessment process, including:
  - All aspects of the risk management process are reviewed at least once a year;
  - Risks identified are subject to review with appropriate frequency; and
  - Provisions for alerting the appropriate level of management to new or emerging risks, as well as changes in already identified risks, so that the change can be appropriately addressed.
- Identify, document, and communicate MICP roles and responsibilities. Ensure proper groups and personnel are involved at the appropriate levels to produce the most results-based, cost-effective control environment.
- Develop, document, and maintain supporting documentation as a part of the MICP and for the SOA as evidence that DLA developed management control plans, performed risk assessments, performed ongoing monitoring, developed corrective action plans, and tracked progress towards remediation for each separate fund.
- Provide formal training and guidance on an annual basis, to those involved in the MICP to ensure roles, responsibilities and objectives are properly understood, carried out in a timely manner, and executed consistently across the organization.
- Increase the resources dedicated to the A-123 program, as needed, to completely execute all aspects of the program requirements on an on-going basis.
- Utilizing the updated risk assessment, DLA should design and implement a control testing strategy appropriate to address the risks.
- DLA should evaluate the current review controls identified to operate over an entire

process:
  - Evaluate single controls to determine if multiple controls actually exist in the process.
  - Evaluate controls to determine if they are designed to appropriately mitigate identified risks.
  - Assess control descriptions to ensure they are documented completely, including how the control is applied, who is responsible, how frequently it is performed, and how the control is evidenced.
- Evaluate the current policies and procedures for evaluating information produced by the entity.
  - Foot system generated financial reports.
  - Perform a tie-out of system generated reports to the trial balance.
  - Verify that the parameters used to generate the reports or data are appropriate.
  - Judgmentally select a sample of transactions or balances in the report and validate that the transactions are accurate.
- Implement a process to identify, monitor, and maintain related parties and material related party transactions. Additionally, management should perform a review of these sales transactions on a regular basis and disclose any material related party transactions in the notes to their financial statements.
- DLA should develop and maintain internal control documentation relating to the identification of related parties and related party transactions.
- DLA should analyze if current policies and procedures are sufficient for the process and update if necessary.
  - Ensure that appropriate personnel are involved in the process.
  - Evaluate that proper roles and responsibilities are identified and communicated.
  - Ensure timelines are defined.
- DLA should determine if controls need to be established for the SOC 1 review process and ensure controls are properly identified, designed and operating effectively.
- DLA should associate specific DLA controls to CUECs, as well as system and organization controls determined to be ineffective.
- Update the Funds Management PCM to accurately reflect all aspects of the end-to-end budget to execute process, including processes and controls performed by DLA and by service providers.
- Design and implement internal controls and procedures to ensure that the performance of review controls are adequately documented and supported by evidential matter, variance thresholds used in the performance of the review are precise, and identify the key related supporting documentation as part of the view.
- Develop a timeline and procedure to continue to update the Funds Management PCM as the processes, internal controls, policies, and individuals performing the control change.

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VIII. Financial Information Systems

Information systems controls are a critical component of the Federal government's operations to manage the integrity, confidentiality and reliability of its programs and activities and assist with reducing the risk of errors, fraud or other illegal acts. Information management security, access controls, segregation of duties, and configuration management controls are fundamental to the integrity of financial data and can help manage risks such as unauthorized access, changes to critical data, and preventing compromised data. The nature, size, and complexity of DLA's operations require DLA to administer its programs under a decentralized business model by using numerous geographically dispersed operating locations and complex, extensive information systems.

Our assessment of the Information Technology ("IT") controls and the computing environment identified deficiencies in the design and operation of information systems controls. We reviewed each finding individually as well as in aggregate. We have identified four deficiencies which, when aggregated, result in a material weakness related to the oversight and monitoring of internal control.

The deficiencies relate to the following areas:

- Access controls / user access
- Configuration management / change controls
- Segregation of duties controls
- Security management / governance over implementation of security controls

(a) Access controls / user access

Access controls include those related to protecting system boundaries, user identification and authentication, authorization, protecting sensitive system resources, audit and monitoring, and physical security. When properly implemented, access controls can help ensure that critical systems assets are physically safeguarded and that logical access to sensitive computer programs and data is granted to users only when authorized and appropriate. Weaknesses in such controls can compromise the integrity of sensitive data and increase the risk that such data may be inappropriately used and/or disclosed.

The identified access control weaknesses that represent a significant risk to the DLA financial management information systems environment include the following:

- Access was not restricted to authorized users and was not assigned in accordance with the principle of least privilege.
- Lack of monitoring and auditing security violations and sensitive user activities, including activities of privileged users logs were not documented, not being performed, or not configured appropriately within systems.
- Lack of enforcement for procedures related to establishing new users, monitoring unused

IDs, locked IDs, terminated users, or access re-certifications.
- Lack of policies and procedures for account authorization, provisioning, and termination.

(b) Configuration management / change controls

Configuration management involves the identification and management of security features for all hardware and software components of an information system at a given point and systematically controls changes to that configuration during the system's life cycle. By implementing configuration management controls, DLA can ensure that only authorized applications and software programs are placed into production through establishing and maintaining baseline configurations and monitoring changes to these configurations. Weaknesses in such controls can compromise the integrity of sensitive data and increase the risk that such data may be inappropriately used and disclosed.

The identified change control weaknesses that represent a significant risk to the DLA financial management information systems environment include the following:

- Inability to identify all application changes made to production during the audit period.
- Lack of monitoring and recording of changes made to applications by DLA management.
- Users have access privileges enabling them to bypass the configuration management process and make changes directly to production.

(c) Segregation of duties ("SoD") controls

An effective control environment guards against a particular user having incompatible functions within a system. Segregation of duties controls provide policies, procedures, and an organizational structure to prevent one or more individuals from controlling key aspects of computer-related operations and, thereby, conducting unauthorized actions or gaining unauthorized access to financial management information systems.

The identified weaknesses that represent a significant risk to the DLA financial management information systems environment include the following:

- DLA management did not identify segregation of duties conflicts that consider both IT and business process roles and activities across DLA-owned applications.
- Application program management has not completely identified sensitive (financial transactions) roles in order to identify and implement appropriate segregation of duties.
- Segregation of duties review within the user provisioning process is not performed consistently across all applications.
- Administrator and super user privileges are not restricted through user groups and permissions. In some cases, users can create and assign roles to themselves, including Defense Information Systems Agency (DISA) administrators.
- Business end users have access to roles intended for IT privileged users.

Building a better working world

(d) Security Management / governance over implementation of security controls

An entity-wide information security management program is the foundation of a security control structure and a reflection of senior management's commitment to addressing security risks. The security management program should establish a framework and continuous cycle of activity for assessing risk, developing and implementing effective security procedures, and monitoring the effectiveness of these procedures. Overall policies and plans are developed at the entity-wide level. System and application-specific procedures and controls implement the entity-wide policy. Without a well-designed program, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

The identified security management control weaknesses that represent a significant risk to the DLA financial management information systems environment include the following:

- System and organization control (SOC) reports are not reviewed, specifically, to assess complementary user entity controls (CUECs). In addition, service level agreements (SLAs) with DISA are not reviewed and updated in a timely manner.
- Lack of application specific access control policies/procedures to consider unique business rules/processes, roles and responsibilities, and technologies.
- Security controls were not assessed or tested within required timeframes.

Recommendations

DLA should implement controls to address deficiencies in access controls, configuration management, segregation of duties, and security management procedures to include:

Access controls / user access / segregation of duties

- Restrict access to authorized users in accordance with least privilege principles.
- Document and follow procedures related to user account management and segregation of duties.
- Implement stronger security controls and restricting user access to programs and data to the minimum level required by the user's responsibilities, to include encrypting sensitive data.
- Identify sensitive business transactions in application business and privileged roles, segregate these roles and where conflicting roles are required or unavoidable, document business rationale and monitor activities of users.

Building a better working world

Configuration management / change controls

- Identify and monitor applications changes made in the production environment.
- Segregate developers' access to the development and production environments.

Security Management / governance over implementation of security controls

- Implement stronger security controls to improve the security documentation and testing of applications.
- Establish a process to evaluate and incorporate service providers' CUECs into security documentation and the current application control environment.

Appendix B - Significant Deficiency

I. Environmental Liabilities

Environmental liabilities (EL) comprise clean-up costs associated with the restoration of sites on real property that DLA manages. Through our audit procedures, we identified deficiencies in internal controls listed below, which, when aggregated, we consider to be a significant deficiency.

DLA lacks policies and procedures in place to reconcile EL associated with its real property, such as buildings, fuel storage tanks, and pipelines, to the real property, such as buildings, tanks, and pipelines, reported in its financial systems:

- DLA is unable to substantiate that a reconciliation is performed to verify that the tanks and pipelines used to estimate the EL is complete and accurate. Environmental regulations require that environmental restoration procedures be performed when a tank or pipeline is permanently placed out of service. In order to appropriately determine the existence and completeness of EL, the tanks and pipelines reported as real property assets should be considered.
- DLA is unable to substantiate the existence, completeness and obligation of EL. As previously reported, DLA does not have policies and procedures to identify the real property assets for which DLA is the FRO, which does not allow DLA to demonstrate their obligation to perform the environmental remediation for the real property asset.

DLA is unable to substantiate the cost to complete estimates for environmental liabilities:

- Policies and procedures are not in place that adequately demonstrates the methodology used to derive the estimate was appropriate.
- The supporting documentation does not appropriately substantiate the estimate for the cost to complete the clean-up and restoration.

DLA is unable to substantiate the program management (PM) cost estimates for environmental liabilities:

- Policies and procedures not in place that adequately documents the methodology used to derive the estimate.
- The supporting documentation does not appropriately substantiate the estimate for the program management costs.

DLA has not appropriately designed controls to adequately detect material misstatements in EL:

- Controls are not designed to verify the completeness and accuracy of the system generated reports or data used in executing the control activity. DLA's EL control activities, including deriving the EL estimates, are dependent upon system-generated reports or data produced by information systems.

Recommendations

EY recommends that DLA consider the following corrective actions related to the deficiencies identified above:

- Design and implement policies and procedures to ensure that a reconciliation is performed between the buildings, tanks, and pipelines in the environmental closure and asbestos liabilities estimate and the PP&E listings in EBS. The differences between the two listings should be investigated to assess whether the environmental closure liabilities is complete and accurate.
- Design and implement policies and procedures to ensure that process for preparing the cost to complete estimate is adequately documented and sufficiently describes the methodology used to derive the estimate.
- DLA should include procedures to verify that the supporting documentation used to derive the estimate properly reconciles to the cost to complete estimate.
- DLA should adequately document the qualifications of the specialist used in deriving the estimate to ensure and demonstrate that the specialists have the necessary competence, capabilities, and objectivity.
- Design and implement policies and procedures that adequately describe the process for preparing the estimate of the EL PM costs. The description should include sufficient detail for a reviewer to understand the process and evaluate whether the process used is reasonable and consistent with the policy.
- Implement policies and procedures to verify that the system generated reports or data used in the performance of the control is complete and accurate such as:
  - Foot system generated inventory reports;
  - Perform a tie-out of the system generated reports to the trial balance;
  - Verifying that the parameters used to generate the reports or data are appropriate
  - Judgmentally selecting a sample of transactions or balances in the report and validating that the transactions are accurate.

Appendix C – Status of Prior Year Deficiencies

Area	Type of Deficiency in Fiscal Year 2017	Current Year Status
Inventory	Material Weakness	Not Remediated
Property, Plant, and Equipment	Material Weakness	Not Remediated
Fund Balance with Treasury	Material Weakness	Not Remediated
Accounts Receivable	Material Weakness	Not Remediated
Accounts Payable	Material Weakness	Not Remediated
Financial Reporting	Material Weakness	Not Remediated
Oversight and Monitoring	Material Weakness	Not Remediated
Information Systems	Material Weakness	Not Remediated
Environmental Liabilities	Significant Deficiency	Not Remediated

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Report of Independent Auditors on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with *Government Auditing Standards*

The Director of the Defense Logistics Agency and
The Inspector General of the Department of Defense

We were engaged to audit, in accordance with auditing standards generally accepted in the United States, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and the Office of Management and Budget ("OMB") Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements,* the financial statements of the Working Capital Fund of the Defense Logistics Agency ("DLA"), which comprise the balance sheet as of September 30, 2018, and the related statements of net cost, changes in net position, and combined statement of budgetary resources for the year ended September 30, 2018, and the related notes to the financial statements, and have issued our report thereon dated November 14, 2018. That report states that because of matters described in the Basis for Disclaimer of Opinion paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements as of and for the year ended September 30, 2018 and the related notes to the financial statements.

Compliance and Other Matters

In connection with our engagement to audit the financial statements, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 19-01, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 ("FFMIA") (P.L. 104-208). However, providing an opinion on compliance with those provisions was not an objective of our engagement, and accordingly, we do not express such an opinion. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to DLA.

The results of our tests of compliance with laws, regulations, contracts and grant agreements described in the preceding paragraph disclosed instances of noncompliance and other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 19-01, and which are described below. In addition, if the scope of our work had been sufficient to enable us to express an opinion on the financial statements, other instances of noncompliance or other matters may have been identified and reported herein.

FFMIA

Under FFMIA, we are required to report whether DLA's financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards, and the United States Standard General Ledger ("USSGL") at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. The results of the tests disclosed instances in which DLA's financial management systems did not substantially comply with federal financial management system requirements, applicable federal accounting standards or the USSGL.

(a) Federal financial management system requirements

EY identified as part of the Financial Information Systems material weakness, contained in the *Report of Independent Auditors on Internal Control Over Financial Reporting Based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards* ("Report on Internal Control"), noncompliance with federal financial management system requirements for multiple systems. Weaknesses identified include those associated with user access, configuration management/change controls, segregation of duties, and security management. These financial system deficiencies prevent DLA from being compliant with federal financial management system requirements and inhibit DLA's ability to prepare complete and accurate financial reporting.

(b) Noncompliance with applicable federal accounting standards

As referenced in Note 1.B. to the financial statements, DLA self-identified that the design of their financial and non-financial systems does not allow DLA to comply with applicable federal accounting standards, including not being able to collect and record financial information as required by U.S. generally accepted accounting principles. EY also identified noncompliance with federal accounting standards during our testing, which was included in our Report on Internal Control.

(c) Noncompliance with USSGL posting logic at the transaction level

EY also identified noncompliance with USSGL posting logic during our testing, which was included in our Report on Internal Control.

FMFIA

Federal Managers' Financial Integrity Act ("FMFIA") requires ongoing evaluations and reports of the adequacy of the systems of internal accounting and administrative control.

DLA was not able to provide evidence that they are in compliance with significant aspects of Circular A-123, which implemented FMFIA. DLA provided a FY 2018 Statement of Assurance, however there was not sufficient evidence that each process identified by DLA fully completed an organizational risk assessment, identified relevant risks related to the financial statement assertions, documented the internal control standards as it relates to those assertions, performed internal control testing, and reported and tracked control deficiencies at the control level. Based on the evidence received, EY notes that DLA has an A-123 testing strategy, however DLA is unable to provide evidence that the extent of testing and review performed is sufficient to meet the requirements of FMFIA.

DLA's Response to Findings

Our Report on Internal Control dated November 14, 2018 includes additional information related to the financial management systems and internal controls that were found not to comply with the requirements, relevant facts pertaining to the noncompliance with FFMIA and FMFIA, and our recommendations to the specific issues presented. Management agrees with the facts as presented and relevant comments from DLA's management responsible for addressing the noncompliance are provided in the accompanying letter dated November 14, 2018. DLA's response was not subjected to the auditing procedures applied in the engagement to audit the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance and the result of that testing, and not to provide an opinion on DLA's compliance. This report is an integral part of an engagement to perform an audit performed in accordance with *Government Auditing Standards* in considering DLA's compliance. Accordingly, this communication is not suitable for any other purpose.

Ernst + Young LLP

November 14, 2018

Management's Response to Audit Reports

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD
FORT BELVOIR, VIRGINIA 22060-6221

NOV 14 2018

MEMORANDUM FOR DEPARTMENT OF DEFENSE OFFICE OF THE INSPECTOR GENERAL

SUBJECT: Fiscal Year (FY) 2018 Financial Statement Audit – Working Capital Fund

Thank you for the opportunity to comment on the Independent Auditors' report on the audit of the Defense Logistics Agency's (DLA) FY 2018 financial statements. We agree with the Independent Public Accountant's (IPA) conclusions for the DLA Financial Statement Audit. This audit has provided us with a valuable and independent view of our current financial operations. We concur with the reported findings as presented by the IPA.

For FY 2018, the engagement with the IPA was a positive partnership that facilitated an effective and efficient audit. The IPA's continual updates to our management team provided on-going insight during the audit. To enhance DLA's process we have stood up an Audit Task Force to oversee and execute the coordination, integration and synchronization of Audit efforts across the Agency. The Audit Task Force will:

- Create Common Operating Picture for Enterprise-wide visibility.
- Address the material weaknesses associated with high priority areas in order to manage and coordinate DLA's financial compliance and audit response functions for accurate and reliable financial statement reporting and operational effectiveness.
- Establish leadership, policy, guidance, and oversight to ensure enduring compliance with Office of Management and Budget Circular A-123.

Overall, we are committed to resolving the material weaknesses and strengthening internal controls around DLA's operations.

I look forward to working collaboratively with the Office of the Inspector General and the IPA to strengthen DLA financial management and internal controls.

DARRELL K. WILLIAMS
Lieutenant General, USA
Director

Air Force General Paul J. Selva, Vice Chairman of the Joint Chiefs of Staff, boards a C-130 aircraft after visiting troops at Kandahar Air Field, Afghanistan, April 26, 2018. Kandahar Air Field was the fourth stop on the annual Vice Chairman's USO tour.

Other Information (Unaudited)

The ***Other Information (Unaudited)*** section contains information on Foregone Revenue, Management Challenges, Summary of Financial Statement Audit and Management Assurances, Payment Integrity, and the Fraud Reduction Report.

Foregone Revenue

DLA provides a fuel service to both military and public entities. The price for fuel supplied is determined by OSD. Often, DLA prices do not match market prices, and therefore DLA incurs a loss in terms of foregone revenue. Foregone revenue denotes the difference between earnings actually achieved and earnings that could have been achieved with the absence of specific fees, expenses, or lost time. DLA Energy incurred foregone revenue from fuel sales totaled $1.3 billion for the year ended September 30, 2018. DLA expects to recoup part of the forgone revenue through a direct appropriation from Congress. The demand for the quantity of petroleum products did not change as a result of the difference in price.

Foregone Revenue (in thousands)

	FY2018	FY2017	FY2016	FY2015	FY2014
Foregone Revenue					
Energy	$ (1,305,045)	$ (882,729)	$ -	$ -	$ (763,841)
Total Foregone Revenue	$ (1,305,045)	$ (882,729)	$ -	$ -	$ (763,841)

Management Challenges

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August 6, 2018

MEMORANDUM FOR LTG DARRELL K. WILLIAMS, DIRECTOR, DLA

SUBJECT: Major Management and Performance Challenges Facing the Defense Logistics Agency Working Capital Funds

Although significant progress has been made in the management of the organization and the reduction of challenges facing the organization, the Office of the Inspector General sees five areas where major challenges remain. The five challenge areas are:

a. Nonconforming inventory. Regardless of the manner in which nonconforming inventory is inducted into the system, the potential risks to the warfighter remain the same.

b. Pricing. Market consolidation, long-term contracts, and socioeconomic programs are decreasing the ability of DLA to foster competition and lower prices.

c. Cybersecurity of DLA systems. Reliance on computer operations to conduct daily business exposes the organization to a myriad of new and increasing computer security threats.

d. Evidential matter. As DLA completes our annual full financial statement audit, we have learned that our ability to locate appropriate evidential matter for audit readiness is just as important as appropriately processing the transaction.

e. Knowledge management. DLA needs to move from the reactionary data management mentality to a more proactive ability to appropriately summarize our vast data into useful and actionable knowledge that management can act upon.

These critical business fundamentals are necessary for DLA to achieve an unmodified financial statement position, as well as to provide the best value to the taxpayer and the best support to the warfighter.

WILLIAM A. RIGBY
Inspector General

Summary of Financial Statement Audit and Management Assurances

The Audit Reports on the FY2018 WCF financial statements identified material weaknesses for the WCF. Table 1 below provides a summary of the financial statement audit results for FY2018.

Table 1: FY2018 Summary of the Financial Statement Audit Results

Audit Opinion :	Disclaimer				
Restatement :	No				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Inventory	1				1
Property, Plant & Equipment	1				1
Fund Balance with Treasury	1				1
Accounts Receivable	1				1
Accounts Payable	1				1
Financial Reporting	1				1
Oversight and Monitoring	1				1
Information Systems	1				1
Total Material Weaknesses	**8**	**-**	**-**	**-**	**8**

DLA does not provide assurance on Internal Controls over Reporting. Management has performed its evaluation, and no assurance is provided based on the cumulative assessment work performed on Financial Reporting; Budgetary Resources; Fund Balance With Treasury (FBwT), Human Resources and Payroll Management; Procurement Management; Property. Plant, and Equipment (PP&E); and Sales Revenue across the DLA. DLA management began remediation efforts in FY2018 and will continue in FY2019. New material weaknesses were identified by DLA management as a result of the assessment work performed in FY2018. Table 2 provides those areas where material weaknesses were identified and remediation work continues for DLA.

Table 2: Summary of Management Assurances

Effectiveness of Internal Control over Reporting (FMFIA § 2)						
Statement of Assurance	No Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consol.	Downgraded to Deficiency	Ending Balance
Financial Reporting - Unresolved variances for key reconciliations	1					1
Financial Reporting - Period-end Close review process requires improvement	1					1
Financial Reporting - Timely compilation of Agency Financial Report and components	1					1
Financial Reporting - The Budgetary to Proprietary reconciliations for the Working Capital Fund (WCF) are not performed on a timely basis and include cumulative differences with incomplete or unsupported explanations	1					1
Financial Reporting – The eliminations issue was identified while performing period-end close procedures	1					1
Plan to Stock – Inventory Reconciliation Framework Design and Implementation	1					1
Acquire to Retire – An effective, consistently applied standardized process is not in place to ensure recorded real property assets are supported by adequate evidential matter for valuation and recording of real property	1			1		
Acquire to Retire – An effective, consistently applied physical inventory process is not in place to ensure recorded real property assets exist and that real property records are complete	1			1		
Fund Balance with Treasury (FBwT) – DLA is unable to provide sufficient, competent evidential documentation to support undistributed collection items	1			1		
FBwT – DLA is unable to provide sufficient, competent evidential documentation to support undistributed disbursement items	1			1		
FBwT – Standard processes for the FBwT reconciliation process were not fully documented	1			1		

Effectiveness of Internal Control over Reporting (FMFIA § 2)						
Statement of Assurance	No Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consol.	Downgraded to Deficiency	Ending Balance
Acquire to Retire - Lack of Management Review for controls related to Plant, Property, and Equipment (PP&E)		1				1
Acquire to Retire - Lack of documentation of real property quantity		1				1
Acquire to Retire - Lack of evidence to support the Rights assertion over real property assets		1				1
Acquire to Retire - Inconsistent policy for grouping real property and general equipment assets		1				1
Acquire to Retire - Lack of reconciiation between real property asset listing and the amounts recorded in the financial statements footnotes		1				1
Acquire to Retire - Inability to provide a listing of additions and deletions for real property or general equipment		1				1
Procure to Pay - Lack of segregation of duties in the Government Purchase Card (GPC) process		1				1
Financial Reporting - Inadequate review of completeness and accuracy of system generated reports and data used in the execution of internal controls in the financial reporting process		1				1
Financial Reporting - Lack of sufficient review and monitoring of DFAS System and Organization Controls (SOC) 1 report related to Financial Reporting		1				1
FBwT - Lack of complete and accurate Department 97 Report Reconciliation Tool (DRRT) policies and procedures .		1				1
FBwT - Inability to reconcile FBwT		1				1
Financial Reporting - Insufficient documentation for calculation and posting of allowance for doubtful accounts		1				1
Total Material Weaknesses	11	12	-	5	-	18

Effectiveness of Internal Control over Operations (FMFIA § 2)						
Statement of Assurance	No Assurance					
Material Weaknesses	Beginning Balance	New	Resolved	Consol.	Downgraded to Deficiency	Ending Balance
Management of First Article Test Exihibits - Checks demonstrates inadeqate Chain of Custody between Initial Production items required to be tested prior to contract award and full rate production, Custody at the Air Force Lab-Tinker AFB and financial payments for item(s) when retained by Service, and DLA distribution role. No Enterprise Policy in place for Air Force driven actions		1				1
Risk of HAZMAT materiel not being segregated properly by Hazardous class caused by inadequate knowledge of HAZMAT segregation requirements or inadequate compliant storage space resulting in a potential safety hazard	1				1	
Certain items within Medical Supply Chain are critical for war readiness. However there are cases where the item (e.g. Antidote Treatment Nerve Agent Auto-injector, 2-PAM Atropine, or key ingredients of these items are provided by a sole source	1					1
DLA does not have valid real property agreements establishing DLA rights and obligations for occupying the real property	1				1	
Controls over the processing of Product Quality Deficiency Reports (PQDRs) were found to be ineffective in DoD Information Assurance Report	1				1	
Customers are not verifying receipt of material	1					1
Total Material Weaknesses	5	1	-	-	3	3

Compliance with Federal Managers Financial Integrity Act (FMFIA § 4)						
Statement of Assurance	No Assurance					
Non-Compliance	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Security Management: • System Security Plan conformance and completeness across financial systems • Policies and procedures out of date or not approved • Monitoring of service provider and demonstrating evidence of complementary User Entity Control completion	1					1
Access Controls: • Coverage and details within Account Management Policy – Increase stringency in areas of risk • Financial system Compliance with Account Management Policy – ensure all systems are in alignment to policy • Alignment of Provisioning Tools with Account Management Policy – ensure tools that support account request and approval of user roles. • Clarify Transaction-code alignment to role in system – identify business and Information Technology (IT) functions within systems that are higher risk or critical to both financial reporting and IT system management	1					1

Compliance with Federal Managers Financial Integrity Act (FMFIA § 4)						
Statement of Assurance	No Assurance					
Non-Compliance	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Segregation of Duties: • Issues with Firefighter roles – ensure Firefighter roles are provisioned only when needed and activity is promptly reviewed to ensure Firefighter roles are provisioned only when needed and activity is promptly reviewed to ensure Fighter use was appropriate • Segregation of Duties in Software Development Life Cycle	1					1
Contingency Planning: • Defense Medical Logistics Standard Support Continuity of Operations Plan (COOP) environment – ensure COOP environment is established and tested regularly	1					1
Total Non-Compliances	4	-	-	-	-	4

Compliance with Section 803(a) of the Federal Financial Management Improvement Act (FFMIA)		
FFMIA Fundamentals	**Agency**	**Auditor**
Federal Financial Management Requirements	Lack of compliance noted	Lack of compliance noted
Applicable Federal Accounting Standards	Lack of compliance noted	Lack of compliance noted
USSGL at the Transactional Level	Lack of compliance noted	Lack of compliance noted

Table 3 below summarizes DLA management's self-identified material weaknesses in internal controls as well as planned corrective actions for the WCF. DLA is currently evaluating the outcome of the corrective actions taken so far to determine whether the current corrective action plans (CAPs) will remediate the material weaknesses identified, or if the plans need to be modified to remediate the deficiencies. Based on results of the evaluation, the completion date of the CAPs will be updated accordingly.

Table 3: Corrective Actions

Material Weakness	Corrective Action Summary
Acquire to retire - Inability to provide a listing of additions and deletions for real property or general equipment	DLA will perform a full physical inventory to establish a baseline for the real and general property assets owned will be established. Once baseline is established, ensure that an accurate listing of additions and deletions will be available through normal Enterprise Business System (EBS) configuration and procedures
Acquire to retire - Inconsistent policy for grouping real property and general equipment assets	DLA is revising the policies to define a consistent methodology for grouping of assets; developing an internal control to verify assets are recorded in EBS in accordance with the new policy
Acquire to retire - Lack of documentation of real property quantity	DLA is evaluating the current process to develop viable solutions for the collection and retention of documentation supporting linear asset quantities
Acquire to retire - Lack of evidence to support the Rights assertion over real property assets	DLA is working with the military services to obtain and validate documentation supporting all real property and determine that DLA is the Financial Reporting Organizations for those assets
Acquire to retire - Lack of Management Review for controls related to Property, Plant, and Equipment (PP&E)	DLA is revising the property management process in order to design appropriate management controls related to the accounting and management of the property assets
Acquire to retire - Lack of reconciliation between real property asset listing and the amounts recorded in the financial statements footnotes	DLA is developing a timely and effective reconciliation process between real property asset listings and amounts presented in the financial statements footnotes
Fund Balance with Treasury (FBwT) - Inability to reconcile FBwT	In collaboration with Defense Finance and Accounting Service (DFAS), DLA is developing a FBwT reconciliation process
FBwT - Lack of complete and accurate Department 97 Report Reconciliation Tool (DRRT) policies and procedures	DLA is developing policies and procedures to monitor and correct undistributed funds and to assist DFAS with the research and the clearing process

Material Weakness	Corrective Action Summary
Financial Reporting - Inadequate review of completeness and accuracy of system generated reports and data used in the execution of internal controls in the financial reporting process	DLA will document a control procedures that documents that should be performed to each system generated reports and data used in the execution of internal controls in the financial reporting process to ensure completeness and accuracy
Financial Reporting - Insufficient documentation for calculation and posting of allowance for doubtful accounts	DLA is implementing new procedures for the calculation, support, approval and posting of the allowance for doubtful accounts
Financial Reporting - Lack of sufficient review and monitoring of DFAS System and Organization Controls (SOC) 1 report related to Financial Reporting	DLA is implementing sufficient review and monitoring procedures of SOC 1 reports related to financial reporting
Financial Reporting - Period-end Close review process requires improvement	DLA is revising policies and procedures for the Annual Financial Reporting process, including enhancing Management Review Controls over period-end closing procedures
Financial Reporting - The Budget to Procurement reconciliations for the Working Capital Fund (WCF) are not performed on a timely basis and include cumulative differences with incomplete or unsupported explanations	DLA performed a root cause analysis to determine the impediments to reconcile budget to propriety accounts. Currently, the Agency is implementing procedures and providing recommendations to correct the differences noted in the reconciliation and avoid further differences
Financial Reporting – The Eliminations issue was identified while performing period-end close procedures	DLA is updating the Trial Balance Management Process Cycle Memorandum (PCM), Financial Reporting policies, and Standard Operating Procedures (SOPs), to ensure complete and accurate financial reporting, including control procedures over eliminations
Financial Reporting - Timely compilation of Annual Financial Report and components	DLA is revising policies and procedures for the Agency Financial Reporting (AFR) process, including enhancing Management Review Controls over the compilations and drafting of the AFR
Financial Reporting - Unresolved variances for key reconciliations	DLA is in process of improving existing reconciliations by training employees on new procedures for identifying root causes and developing the appropriate corrective actions and monitoring the performance of the new processes

Material Weakness	Corrective Action Summary
Plan to stock – Inventory Reconciliation Framework Design and Implementation	DLA is evaluating the current systems and differences in inventory to design and develop an Inventory Reconciliation process
Procure to pay - Lack of segregation of duties in the Government Purchase Card (GPC) process	DLA is revising and making updates to the current the GPC management process in order to ensure segregation of duties

The governance structure of DLA integrates a system through which business is directed and controlled by establishing rules and procedures for decision making, setting objectives, and specifying the distribution of rights and responsibilities among different participants within DLA, such as the Executive Board, Alignment Group, Stewardship Committee (SC), program working groups, managers, and stakeholders. In accordance with OMB Circular A-123, management monitors and evaluates risk response and internal controls. The OMB Circular A-123 team consists of the SC, Enterprise Business Cycle Owners (EBCOs), Headquarter J/D Code Organizations, MSC Directors/Commanders and their sub-organizations. The SC is the governance structure for ERM and Internal Controls and acts in an Audit Committee capacity by aiding the agency Director and Executive Board in fulfilling Agency Financial Stewardship. The SC/Senior Assessment Team provides oversight of OMB Circular A-123 activities reported to OUSD(C). Process Cycle Integrators for the EBCO coordinates with Assessable Unit Managers and Process Health Leads to ensure proper documentation of business processes that support operational, administrative, system, and financial events to assess controls and improve efficiency in agency mission execution.

To elevate awareness of risk management and establish a risk mitigation strategy, DLA developed a Risk Profile (RP) as the basis for internal control assessments. DLA's approach to controlling risk does not necessarily seek to eliminate the risk, but attempts to reduce risk and monitor its impact on completing mission objectives. The below Enterprise Risk Priority Heat Map includes Enterprise Risks and associated vulnerabilities, as recognized by Senior Leaders. This is conveyed through the Chief Risk Officer for the Agency, the ERM Program Lead, and Risk Managers throughout DLA. DLA's approach to Risk Management is a top-down and bottom-up perspective. The Enterprise Risks fall into 8 overarching categories: Support to Operations, IT Management, Inventory Management, Procurement and Acquisition, Financial Management, Human Resources Management, Customer Satisfaction, and Security and Force Protection. The bottom-up perspective is documented in Local Risk Profiles (LRPs), submitted by DLA Assessable Units. LRPs tie Enterprise Risks to local issues. LRPs ascertain the risk driver, category, impact, end-to-end business process, and strategic objectives associated with each risk at the local level.

Enterprise Risk Priority Heat Map

Risk Area	Impact SUM	Likelihood SUM	Appetite SUM
Support to Operations	45	29	15
Customer Satisfaction	21	18	9
Procurement & Acquisition	25	15	13
HR Management	10	23	4
Security & Force Protection	9	9	1
IT Management	21	26	15
Inventory Management	36	25	18
Financial Management	45	24	15

A worst case scenario would be
1) high likelihood of occurrence
2) high impact
3) high level of unpreparedness
should the event occur
(represented by a big bubble)

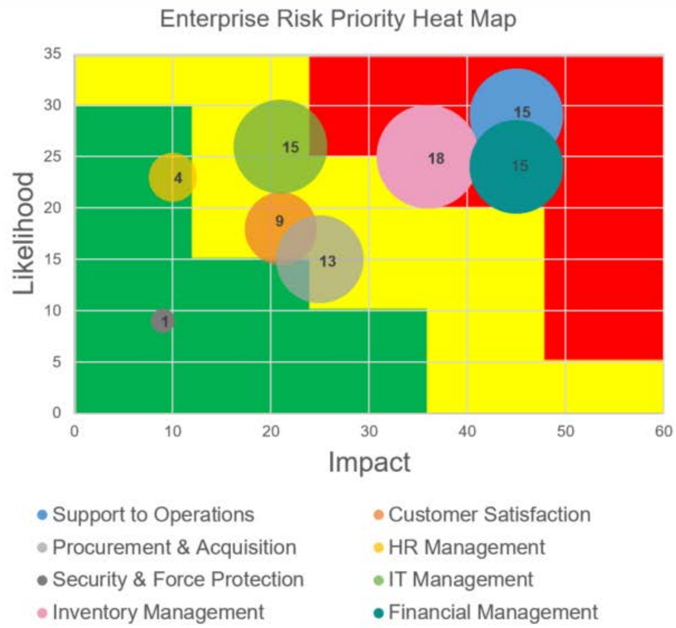

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Figure 5, Enterprise Risk Priority Heat Map

Internal Control over Operations

The prior year's risk profile served as the guide for the operational processes to evaluate in FY2018. DLA utilizes a variety of techniques to evaluate its operational effectiveness, efficiency, and compliance, including management evaluation, self-reporting, and internal and external review. Various avenues of testing highlight risk areas and potential fraud indicators. Highlighted below are test results from the Agency Management Review (AMR) and the Distribution Quality Control and Quality Assessments Results.

The AMR Program, led by DLA Logistics Operations, is the foundation for operational internal control assessments and operational compliance. The AMR Program is a cross-functional evaluation of DLA's compliance with the laws, regulations, policies, and procedures covering operations in selected areas. The AMR Program allows for examination of operationalized activities, as well as observation of processes outside the scope of current policies and procedures, and identification of best practices. Evaluation criteria and tolerance rate were predetermined for each review topic. Scores consist of: pass, pass with comments, fail, or not applicable after completion of the review.

The following table includes areas evaluated in FY2018 as applicable to DLA Logistics Operations mission.

Focus Area	DLA Troop Support	DLA Distribution
Service Management Quality Assurance Plan	Pass	Pass
Service Management customer-Supplier Operations Procedures	Fail	Fail
Customer Relationship Management Program Support	Pass	Pass
Opportunity Management	Pass	NA
Unfilled Customer Orders	Pass	NA
Backorder Management	Fail	NA
Intermediate Document Processing	Pass	NA
Forecast Override	Pass	NA
Logistics Reassignment	Pass	NA
Testing First Article	Pass	NA
Demilitarization	Pass	NA
Demilitarization Training	Pass with comments	NA
Packaging Policy and Procedures	Fail	Pass with comments
Product Quality Deficiency Report Process	Pass with comment	Pass with comment
Price Changes Authorized	Fail	NA
Shelf Life Management	NA	Pass
Transportation Policy	NA	Pass with comments
Physical Inventory	NA	Pass
Supply Discrepancy Reports	NA	Pass

The Quality Control (QC) and Quality Assessment (QA) programs have test plans and test methods developed for areas to be tested. Methods of testing and sampling techniques utilized consist of random sampling (utilizing a random number generator), 100% inspection, direct observation, and re-performance. QC has a minimum sample size of 45 per control per month while QA is generally determined by workload in that area or utilizing a random number generator, or a combination of any of the methods and sampling techniques mentioned. All controls tested were manual controls. In the testing timeframe for the FY2018 Statement of Assurance (SOA) (October 2017 – February 28, 2018) across all Distribution centers, QC samples were tested in the core Distribution process areas of pick, pack and stow. This resulted in a pass rate of 99.5% which is within the established FIAR tolerance.

Quality Control and Quality Assessment Results

	Pick	Pack	Stow	Total
Samples tested	9,590	8,874	8,620	27,084
Samples passed	9,524	8,832	8,602	26,958
% Pass Rate	99.3%	99.5%	99.8%	99.5%

In the testing timeframe for the FY2018 SOA (October 2017 – February 2018) across all Distribution centers, QA samples were conducted in high-risk areas to include ensuring proper procedures are being followed in areas identified in the FY2018 LRP. These areas include the handling of FMS, Hazardous Material (HAZMAT), Arms, Ammunition and Explosives (AA&E), and Nuclear Weapon Related Materiel (NWRM).

Quality Control and Quality Assessment Results Continued

	Classified	FMS	HAZMAT	AA&E	NWRM	Total Samples	FIAR Tolerance
Sample Size	377	560	517	100	120	1,674	1,674
#Failure	4	-	21	-	-	25	186
%Failure Rate	1.1%	-	4.1%	-	-	1.5%	11.1%

DLA Distribution's QA program adds another layer of testing by measuring process adherence across operational controls as well as high risk areas across the Distribution network. A total failure rate of 1.49% was determined. Although DLA Distribution takes a "no tolerance" stance on these process areas, DLA will continue to monitor and develop new controls that assist in mitigating these risks.

DLA prioritized developing and implementing corrective action plans to remediate Notice of Findings and Recommendations (NFRs) resulting from the FY2017 Financial Statement Audit. Numerous NFRs focused on the inadequacy of business processes and controls as well as lack of associated policy. Consequently, DLA performed limited OMB Circular A-123 testing since corrective action plans were not completed and process improvements were not yet fully institutionalized or applied.

Moving forward into FY2019, DLA will continue to commit time and resources to the financial statement audit as well as the integration of audit efforts and results with each phase of the Enterprise OMB Circular A-123 Program. OMB Circular A-123 management assessments and the financial statement audit assessments are complementary processes and together provide the information needed to support remediation and effectively sustain an auditable control environment.

Internal Control over Reporting

DLA Finance used several factors to determine which processes to review in FY2018, such as establishing materiality to identify significant financial statement line items. In addition, DLA Finance also assessed inherent risk, impact of the risk event to the financial, reputational, and operational aspects of the Agency, risk mitigation strategies, and dates of when the process was last tested. DLA Finance also considered existing deficiencies in each process area to determine whether to test the process in FY2018. This included evaluating NFRs from FY2017, which reported material weaknesses and significant deficiencies in various business processes across the Agency. DLA Finance did not select areas that contained significant issues as indicated by the NFRs or existing deficiencies for testing in FY2018 to allow for remediation efforts and corrective actions to be implemented. Based on the various factors discussed above, DLA selected the below process areas in FY2018 for testing.

FY2018 Process Areas

Process Area	Process Cycle Memorandum
Order to Cash	• Disposition Public Sales • Construction and Equipment (C&E)
Hire to Retire	• Employee Record Set-Up and Management • Manage Payroll • Manage Travel Defense Travel System Transactions • Federal Employees' Compensation Act
Acquire to Retire	• Real Property
Fund Balance with Treasury and Financial Reporting and Reconciliation	• Fund Balance with Treasury • Trial Balance Management
Procure to Pay	• Government Purchase Card

For each of the above process areas, DLA identified specific PCMs and key controls to test. For each key control, DLA performed test of design and test of operating effectiveness procedures to evaluate the controls' effectiveness to mitigate the associated financial reporting risk. DLA Finance used a variety of testing methods such as inquiry, observation, inspection and re-performance in the testing. DLA determined the appropriate testing method based on the nature of the control. See the table below for the summary of control test results.

Summary of Test Results (Note: Control testing was not specific for individual funds)

Control Analysis				
Process Cycle	**Process Cycle Memorandum Name**	**Test Description**	**Control Type**	**Results**
Fund Balance with Treasury (FBwT)	FBwT	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	4 controls tested; 4 control failures
Financial Reporting	Trial Balance Management	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	11 controls tested; 11 control failures
Financial Reporting	Invoice to Disbursement	Internal Control Test of Design and Test of Operating Effectiveness	Manual	1 control tested; 1 control failure
Financial Reporting	Billings to Collections	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	4 controls tested; 4 control failures
Order to Cash	Construction & Equipment	Internal Control Test of Design and Test of Operating Effectiveness	Manual	3 controls tested; 2 controls failures
Order to Cash	Disposition Public Sales	Internal Control Test of Design and Test of Operating Effectiveness	Manual	5 controls tested; 4 control failures
Acquire to Retire	Real Property	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	7 controls tested; 4 control failures
Procure to Pay	Government Purchase Card	Internal Control Test of Design and Test of Operating Effectiveness	Manual	2 controls tested; 2 control failures
Procure to Pay	Outbound Military Interdepartmental Purchase Order	Internal Control Test of Design and Test of Operating Effectiveness	Manual	2 controls tested; 2 control failures
Hire to Retire	Manage Payroll	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	4 controls tested; 0 control failures

Process Cycle	Process Cycle Memorandum Name	Test Description	Control Type	Results
Hire to Retire	Federal Employees' Compensation Act	Internal Control Test of Design and Test of Operating Effectiveness	Manual	10 controls tested; 0 control failures
Hire to Retire	Employee Record Set-Up and Management	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	8 controls tested; 0 control failures
Hire to Retire	Manage Travel Defense Travel System Transactions	Internal Control Test of Design and Test of Operating Effectiveness	Automated and Manual	4 controls tested; 0 control failures
Total Results				**65 controls tested; 34 control failures**

For the deficiencies identified as part of management's internal control program, DLA WCF analyzed the deficiencies to determine the relationship to any existing NFRs issued as part of the FY2017 financial statement audit. DLA Finance completed this analysis to ensure that existing corrective actions already underway would address the newly identified deficiencies. For those deficiencies that did not have a relationship to an existing NFR, DLA Finance determined the category of the deficiency by considering whether the control failure would result in a material misstatement to the financial statements. In addition, DLA Finance will develop corrective actions as necessary. DLA also compared open corrective actions reported in the FY2017 SOA to the FY2017 NFRs to ensure that the corrective actions developed for these NFRs covered the existing deficiencies. Based on these factors, internal controls over reporting for DLA are not effective to mitigate the risk of a material misstatement to the financial statements.

Payment Integrity

Payment Reporting

The Improper Payments Information Act of 2002 (IPIA) (Pub. L. 107-300), as amended by the Improper Payments Elimination and Recovery Act of 2010 (IPERA) (Pub. L. 111-204) and Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA); (Pub. L. 112-248), requires agencies to review and assess all programs and activities they administer and identify those determined to be susceptible to significant improper payments, estimate the annual amount of improper payments, and submit those estimates to Congress. In accordance with DoD 7000.14-R Financial Management Regulation (FMR), Volume 4, Chapter 14, *Improper Payments*, DoD components that entitle (i.e. process or compute) payments conduct risk assessments of their payment processes and random post-payment reviews to estimate improper payments. The OUSD(C) Accounting & Finance Policy Directorate (A&FP) compiles the Department-wide results annually as part of DoD's AFR. As DLA's Service Provider, DFAS entitles payments and provides the results of post-payment reviews to OUSD(C) A&FP on behalf of its customers.

The OMB Circular A-123, Appendix D, *Requirements for Payment Integrity Improvement*, also requires agencies to review all programs and activities to determine the risk of making significant improper payments and to perform more in-depth assessments to determine whether those programs meet the criteria for "significant erroneous payments". Although DLA does not currently meet the full requirements of Payment Integrity, DLA will conduct a risk assessment over its program in FY2019.

Recapture of Improper Payments Reporting

High Dollar Overpayments to Individuals and Entities

DFAS conducts a quarterly post payment review on behalf of its customers for high dollar overpayments. Payments from the EBS, Mechanization of Contract Administration Services (MOCAS), and Computerized Accounts Payable System - Windows (CAPS-W) systems were statistically sampled for the period ended June 30, 2018. Based on the results of the review, there were no improper payments identified that resulted in overpayments or underpayments.

System	Sampled Invoices #	Sampled Invoices $
EBS	226	$ 494,497,522
MOCAS*	320	$ 5,142,358,722
CAPS-W*	27	$ 64,347,141
Total	**573**	**$ 5,701,203,385**

**Sampled invoices include other Defense agencies*

Travel Pay

DoD reports improper payment estimates related to the DoD Travel Pay program. DLA conducts a quarterly post payment review of travel vouchers in order to identify and recover improper payments agency wide. The reviews are designed to identify incorrect payment amounts, unauthorized claims, and internal controls over the travel payment process. The DoD goal for the recovery of improper payments is 86% or above. Based on the results of the review for the period ended July 31, 2018, the DLA WCF recovery rate was 83%. DLA will continue to reinforce front-end controls, such as continuing training opportunities, to prevent improper payments and enforce recovery of those identified.

Organization	FY17 Debt Value	FY18 Debt Value	FY17 and FY18 Total Debt Value	Open Debt Vouchers (cumulative)	Open Due US	Debt Paid	DLA DMM Recovery Rate
ACQUISITION (J7)	$ -	$ 6,318	$ 6,318	-	$ -	$ 6,318	100%
AVIATION	$ 910	$ 34,537	$ 35,447	9	$ 3,170	$ 32,278	91%
D-GROUPS	$ 11	$ 2,345	$ 2,357	-	$ -	$ 2,357	100%
DISPOSITION	$ 2,621	$ 23,741	$ 26,362	7	$ 8,779	$ 17,583	67%
DISTRIBUTION	$ 16,907	$ 48,940	$ 65,847	19	$ 25,549	$ 40,298	61%
ENERGY	$ 441	$ 34,324	$ 34,765	10	$ 4,391	$ 30,374	87%
FINANCE (J8)	$ -	$ 5,107	$ 5,107	1	$ 18	$ 5,089	100%
HUM RSC (J1)	$ 14,693	$ 25,369	$ 40,062	8	$ 5,183	$ 34,879	87%
INFO OPS (J6)	$ 1,183	$ 17,547	$ 18,730	4	$ 361	$ 18,369	98%
INSTL SPPT	$ 307	$ 9,741	$ 10,048	2	$ 556	$ 9,491	94%
JOINT RSRV (J9)	$ -	$ 586	$ -	-	$ -	$ 586	0%
LAND & MARITIME	$ 1,421	$ 9,136	$ 10,557	1	$ 536	$ 10,022	95%
LOG OPS (J3/4)	$ 2,988	$ 33,787	$ 36,775	1	$ 70	$ 36,705	100%
STRAT P&P (J5)	$ -	$ -	$ -	-	$ -	$ -	0%
TROOP SPPT	$ 689	$ 22,240	$ 22,929	13	$ 5,945	$ 16,984	74%
	$ 42,170	**$ 273,719**	**$ 315,304**	**75**	**$ 54,558**	**$ 261,332**	**83%**

Fraud Reduction Report

DLA utilized the American Institute of Certified Public Accountants Audit Standard (AU-C) Section 240.04, *Consideration of Fraud in a Financial Statement Audit,* criteria to identify management's responsibility for fraud risk management. Management is responsible for placing a strong emphasis on fraud prevention and fraud deterrence. This responsibility involves creating a culture of honesty and ethical behavior, reinforced by active oversight by those charged with governance to consider the potential for override of controls or other inappropriate influence. DLA utilized the fraud triangle as a means to begin addressing fraud risk management. The fraud triangle is a model for explaining the factors that cause someone to commit occupational fraud. Together, pressure, perceived opportunity, and rationalization lead to fraudulent behavior.

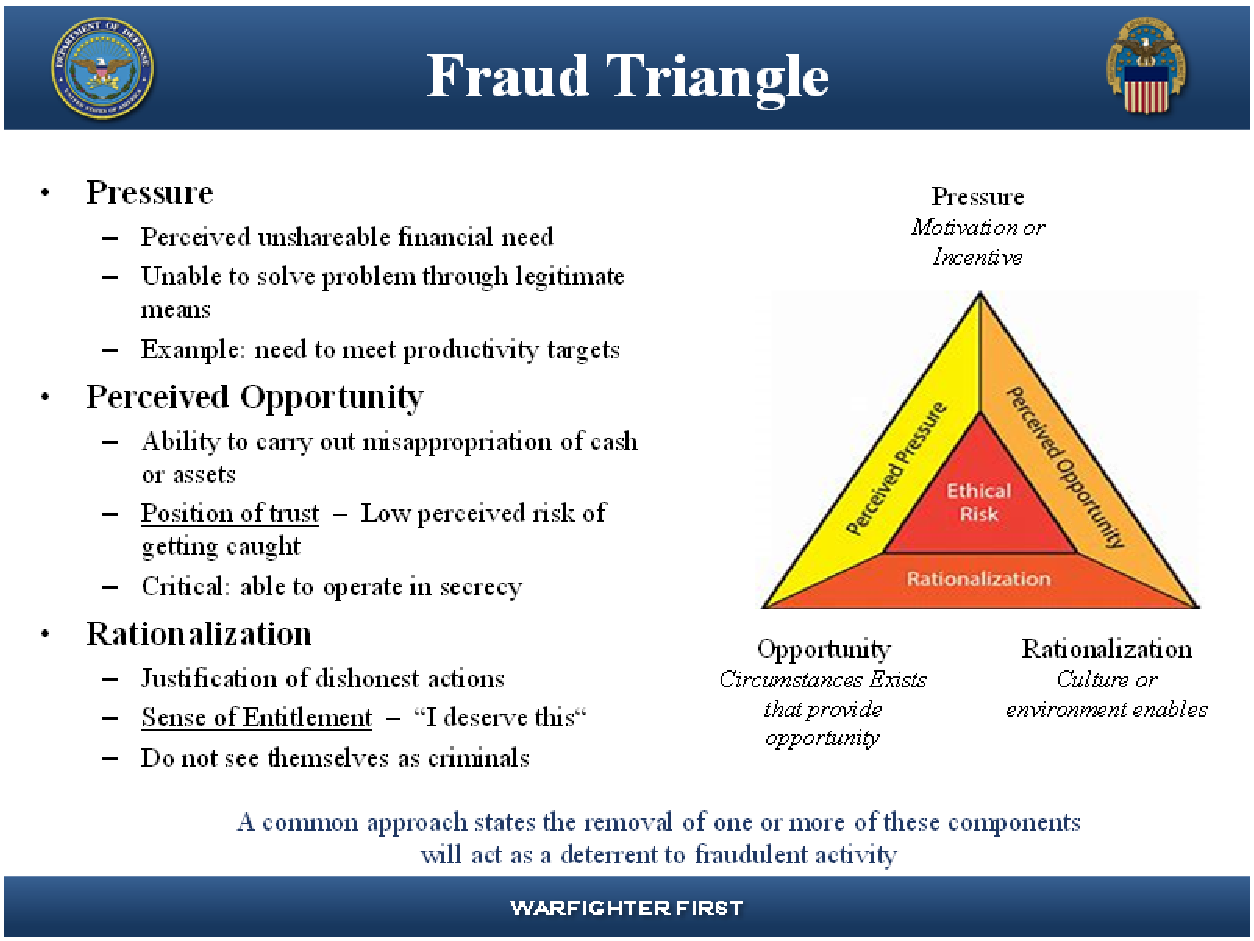

Figure 6, The Fraud Triangle

As part of DLA's efforts in establishing an adequate internal control environment and comply with the Fraud Reduction and Data Analytics Act of 2015 (Pub. L. 114-186, 31 USC 3321), DLA has identified and documented administrative and financial internal controls to address fraud risks. Internal controls include both preventive and detective controls. DLA has identified the following internal controls to address fraud risk:

Anti-Fraud Controls

Anti-Fraud Controls	
Preventive	Detective
1. An Independent Audit Committee	1. Dedicated Fraud Department or Team
2. An Anti-Fraud Policy	2. Whistleblower Hotline
3. Code of Conduct	3. Surprise Audits
4. Management Review	4. Internal Audits
5. Job Rotation and Mandatory Vacation	5. Rewards for Whistleblowers
6. Formal Fraud Risk Assessment	6. External Audit of Internal Controls over Financial Reporting
7. Proactive Data Monitoring and Analysis	7. External Audit of Financial Statements
8. Fraud Training for Employees	
9. Fraud Training for Managers and Executives	
10. Employee Support Programs	
11. Management of Certification of Financial Statements	

DLA has identified five internal control areas where a gap exists and corrective action is needed. These areas are highlighted above and include:

- Establishment of a formal fraud risk assessment policy
- Proactive data monitoring and analysis to identify potential frauds
- Establishing formal fraud training for employees
- Establishing formal fraud training for managers and executives
- Establishing a formal reward program for whistleblowers

These areas will continue to remediate the gaps identified above in FY2019 as DLA makes progress in identifying fraud risk vulnerabilities and establishing strategies and procedures to curb fraud. DLA has the responsibility to develop and maintain effective system of internal control to detect and mitigate the risk of fraud.

Members of the 163d Aircraft Maintenance Squadron,163d Attack Wing, California Air National Guard, conduct a preflight check on the wing's MQ-9 Reaper remotely piloted aircraft before a fire support mission, Aug. 1, 2018, at March Air Reserve Base, California. The wing is supporting state agencies who are battling numerous wildfires in Northern California, including the Carr Fire and Mendocino Complex Fire.

Acronym and Abbreviation List

Acronyms and Abbreviations	
A2R	Acquire to Retire
ADA	Anti-Deficiency Act
AFR	Agency Financial Report
ALT	Alternative Lead-Time
AMR	Agency Management Review
APR	Annual Performance Report
AWARS	Automated Workflow and Reporting System
BRAC	Base Realignment and Closure
CAGE	Commercial and Government Entity
CAPS-W	Computerized Accounts Payable System - Windows
CARS	Central Accounting and Reporting System
CBY	Charge Back Year
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
CFO	Chief Financial Officer
CIO	Chief Information Officer
CIP	Construction in Progress
CMR	Cash Management Report
COLA	Cost of Living Adjustment
CPIM	Consumer Price Index Medical
CRR	Cost Recovery Rate
CSRS	Civil Service Retirement System
CTC	Cost-to-Complete
DAAS	Defense Automatic Addressing System
DDRS	Defense Departmental Reporting System
DRRT	Department 97 Report Reconciliation Tool
DATA	Digital Accountability and Transparency Act
DAWIA	Defense Acquisition Workforce Improvement Act
DFAS	Defense Finance and Accounting Service
DHS	Department of Homeland Security
DLA	Defense Logistics Agency
DLAI	Defense Logistics Agency Instruction
DoD	Department of Defense
DoDAAD	Department of Defense Activity Address Directory
DoDIG	Department of Defense Office of the Inspector General
DOE	Department of Energy

Acronyms and Abbreviations	
DOL	Department of Labor
DPCMP	Data Profiling and Continuous Monitoring Program
DPMAP	DoD Performance Management and Appraisal Program
DSCR	Defense Supply Center Richmond
DTS	Defense Travel System
DWWCF	Defense-Wide Working Capital Fund
EBCO	Enterprise Business Cycle Owner
EBS	Enterprise Business System
EDW	Enterprise Data Warehouse
EEO	Equal Employment Opportunity
EL	Environmental Liabilities
ELC	Entity Level Controls
EM	Evidential Matter
EOPC	Enterprise Operations Planning Council
EOU	Excess, Obsolete, and Unserviceable
ERM	Enterprise Risk Management
eSOP	Enterprise Standard Operating Procedure
FASAB	Federal Accounting Standards Advisory Board
FBwT	Fund Balance With Treasury
FEA	Fuel Exchange Agreement
FECA	Federal Employees' Compensation Act
FEMA	Federal Emergency Management Agency
FERS	Federal Employees Retirement System
FFMIA	Federal Financial Management Improvement Act
FFMSR	Federal Financial Management System Requirement
FIAR	Financial Improvement and Audit Remediation
FISMA	Federal Information Security Modernization Act
FMFIA	Federal Managers' Financial Integrity Act
FMR	Financial Management Regulation
FO	Financial Officer
FR&R	Financial Reporting and Reconciliation
FRO	Financial Reporting Organization
FWAM	Fraud, Waste, Abuse, and Mismanagement
FY	Fiscal Year
GAO	Government Accountability Office
GF	General Fund
GLSC	Global Logistic Support Capability
IG	Inspector General

Acronyms and Abbreviations	
ILSMT	Integrated Logistics Support Management Teams
IPA	Independent Public Accountant
IPERA	Improper Payments Elimination and Recovery Act
IPIA	Improper Payments Information Act of 2002
IT	Information Technology
IUS	Internal Use Software
JPO	Joint Program Office
LM&R	Logistics Material and Readiness
LOE	Line of Effort
LRP	Local Risk Profiles
MAC	Moving Average Cost
MD&A	Management's Discussion and Analysis
MOCAS	Mechanization of Contract Administration Services
MSC	Major Subordinate Command
NATO	North Atlantic Treaty Organization
NC3	Nuclear Command, Control, and Communications
NE	Nuclear Enterprise
NFR	Notice of Findings and Recommendation
NRV	Net Realizable Value
OCONUS	Outside the Continental United States
OCS	Operational Contract Support
OIG	Office of Inspector General
OMB	Office of Management and Budget
OSD	Office of the Secretary of Defense
OTD	On-Time Delivery
OUSD	Office of the Under Secretary of Defense
OUSD(C)	Office of the Undersecretary of Defense, Comptroller
OWCP	Office of Workers' Compensation Programs
P2S	Plan to Stock
PBL	Performance Based Logistics
PLT	Production Lot Testing
PMT	Program Management Team
PP&E	Property, Plant, and Equipment
PPR	Post Payment Review
PSP	Product Support Provider
R&D	Research and Development
RACER	Remedial Action Cost Engineering Requirements
RCRA	Resource Conservation and Recovery Act

Acronyms and Abbreviations	
ROI	Return on Investments
RP	Real Property
RSI	Required Supplementary Information
RSSI	Required Supplementary Stewardship Information
SARA	Superfund Amendments and Reauthorization Act
SBR	Statement of Budgetary Resources
SCM	Supply Chain Management
SCNP	Statement of Changes in Net Position
SES	Senior Executive Service
SFFAS	Statement of Federal Financial Accounting Standards
SFP	Standard Fuel Price
SITREP	Situational Reports
SLB	Service Level Bill
SNC	Statement of Net Cost
SOA	Statement of Assurance
SOC	System and Organization Controls
SOP	Standard Operating Procedures
SS&D	Supply, Storage, and Distribution
TAS	Treasury Account Symbol
TDD	Time-Definite Delivery
TF	Transaction Fund
TFM	Treasury Financial Manual
TSOC	Theater Special Operations Commands
WCF	Working Capital Fund
WoG	Whole of Government
U. S. GAAP	United States Generally Accepted Accounting Principles
USSGL	United States Standard General Ledger

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