

MEMORANDUM FOR THE RECORD

SUBJECT: Joint Physical Inventory Working Group (JPIWG) Meeting, September 28, 2010

ODASD Supply Chain Integration (SCI) and representatives from the OSD Comptroller staff hosted a meeting of the JPIWG, on Tuesday, September 28, 2010 to discuss one of the Department's top priorities, a "clean financial audit"; specifically the task is to validate the existence and completeness of mission-critical assets. The goal of the meeting was to combine Logistics and Comptroller functional communities in a DoD-wide effort to review and develop physical inventory procedures that satisfy the requirements for a clean audit. One aspect of the task was to discuss inventory definitions, with the goal of achieving common definitions or being able to explain necessary differences in policy documents. We also reviewed the status of efforts to develop a single, standard DoD sampling methodology for Service owned assets at the DLA distribution depots. The components were asked for opportunities to achieve early assessment on segments of inventory.

Mr. Paul Peters, Deputy Assistant Secretary of Defense for Supply Chain Integration, provided opening remarks. He emphasized the need for the Logistics community to partner with the Comptroller community in achieving clean audits and asked the group to review the inventory policies to close audit gaps and address areas that could be misinterpreted and cause vulnerabilities, including inventory sampling.

The topic of existence and completeness of mission critical assets was discussed by the Deputy Chief Financial Officer of the Department, Mr. Mark Easton, and Mr. Joe Quinn, Director of Financial Improvement and Audit Readiness (FIAR). The FIAR initiative is to focus on financial information most useful for managers and warfighters and most importantly, to achieve audit readiness. This is essential to:

- Improve mission support
- Comply with laws
- Verify correct allocation of funds
- Increase public trust

In order to prove audit readiness, each Component must assert to the existence and completeness (E&C) of its inventory and operating materials and supplies (OM&S) by proving:

- material on the accountable record exists in storage (existence)
- all material in storage is reflected on the accountable record (completeness)

This assertion must then be documented in an auditable manner. This will be a challenge for DoD because neither the legacy logistics nor legacy financial systems are integrated, nor do all systems collect the required data at the transaction level. Financial management and reporting for inventory and OM&S is dependent upon data from operations, therefore many diverse functional organizations must work together - within the constraints of current systems. SCI reiterated their position that the Department cannot await full implementation of planned ERPs to achieve audit readiness.

The meeting also addressed the General Accounting Office (GAO) review of the physical inventory policies and procedures of several leading edge companies, e.g., Boeing, Honeywell,

and FEDEX. The results of that review are published in the *GAO Executive Guide: Best Practices in Achieving Consistent, Accurate, Physical Counts of Inventory and Related Property (GAO-02-4476)*. The OSD Comptroller used the *GAO Executive Guide* to compare the Department's current physical inventory counting policies and procedures against best practices of industries excelling in their ability to manage inventory and achieve accurate physical counts. Recommendations to the Department to improve existing policy guidance are based upon 12 key factors in achieving consistent and accurate physical counts from the *GAO* report. The policy review included:

- DoD Financial Management Regulation (FMR), Chapters 4 & 6.
- DoD 4140.1-R, Supply Chain Material Management Regulation
- DoD 4000.25-M, Defense Logistics Management System
- DoD 4000.25-2-M, Military Standard Transaction Reporting and Accounting Procedures
- DoD 5100.76-M, Physical Security of Sensitive Conventional Arms, Ammunitions and Explosives

Results showed that although most of the key factors were met or partially met, there was room for improvement. The SCI position is that the Department must be fully accountable, therefore policy must be clear and complete. Final recommendations are:

- to update existing guidance where appropriate to include all key factors cited in the *GAO Executive Guide* described above
- compare policies against applicable accounting and auditing standards to ensure alignment
- establish minimum frequency requirements for routine review of key policies/procedures
- insert a matrix in the FMR which points to all sources of guidance on inventory

During the meeting, SCI discussed each key factor in detail, as it was compared to DoD 4140.01-M. A matrix of the information which was being added or clarified for all factors partially met or not met and its proposed location in DoD 4140.01-M was provided by SCI and then reviewed with all meeting participants.

ACTION ITEM 1: Since the review of proposed text changes was limited to policy in the draft DoD 4140.01-M, Volume 5, SCI agreed to provide to all attendees the supporting physical inventory procedures in the DoD 4000.25 Defense Logistics Management System (DLMS) manual, Volume 2, Chapter 6. Comments to the supporting procedures are not being solicited at this time. Revision to the overarching DoD 4140.01-M policy will drive associated changes to the DLMS procedural manual.

ACTION ITEM 2: The Services, Coast Guard, and DLA are required to review the proposed text changes to DoD 4140.1-R, developed to correct shortfalls in policy and provide concurrence or alternative text changes to meet the key factor requirements. Special attention is required on Key Factor 1, Accountability, Characteristic "c" - Establish accountability for achieving performance goals in employee job descriptions.

DUE: Two weeks from date SCI provides attendees an updated DoD 4140.01-M, Volume 5 incorporating changes from meeting. (Oct 20, 2010)

ACTION ITEM 3: During their review of DoD 4140.01-M, Volume 5, Service, Coast Guard, and DLA representatives are required to review the prioritization levels listed for physical inventories (page 30), and to concur with the order as written, or provide alternate level(s) for prioritization. Consideration must be given to current system environments and the fact that physical inventory selection is item data driven (e.g., controlled inventory item code).
DUE: Two weeks from date of final minutes. (Oct 20, 2010)

OSD Comptroller discussed the definitions for "Inventory" and "Operating Materials and Supplies (OM&S)" found in Federal Accounting Standards Advisory Board (FASAB) policy and in the Financial Management Regulation. Definitions are compared below:

INVENTORY:

- **FASAB:** "...tangible personal property that is held for sale, 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. The principal objective of the sale/transfer of inventory is to provide a product or service for a fee that generally recovers full cost or an identified portion of the cost."
- **FMR:** "...tangible personal property that is held for sale, in the process of production for sale, or to be consumed in the production of goods for sale or in the provisions of services for a fee."

OM&S:

- **FASAB:** "...tangible personal property to be consumed in normal operations. Excluded are goods that have been acquired for use in constructing real property or in assembling equipment..., stockpile materials, goods held under price stabilization programs, foreclosed property, seized /forfeited property and inventory."
- **FMR:** "...tangible personal property to be consumed in normal operations. Excluded are goods that have been acquired for use in constructing real property, stockpile materials, and inventory held for sale."

SCI expressed concern as to whether the term "Inventory" should be re-defined as being held for "...sale or issue..." as currently stated in DoD 4140.1-R: "Materiel, titled to the U.S. Government, held for sale or issue, held for repair, or held pending transfer to disposal." Additional considerations are: monies used to purchase the material or defining by owner. To help with potential changes to the definition in DoD 4140.1-R, the Services were assigned the following action.

ACTION ITEM 4: Service, Coast Guard, and DLA representatives are required to forward their Component definitions for both Inventory and OM&S from both their logistics and financial regulations. **DUE:** Two weeks from date of final minutes. (Oct 20, 2010)

ACTION ITEM 5: SCI tasked the DoD Components to provide an explanation of their inventory valuation methodology. **DUE:** Two weeks from date of final minutes (Oct 20, 2010)

DLA discussed in general, the physical inventory sampling methodology used for Service-owned assets at DLA Distribution Depots. It is important to note that DLA performs physical

inventory in accordance with the sampling plan of the material owner, not the manager. That is, a single stock number managed by DLA, but which has assets owned by DLA and multiple Services, will be inventoried one-way for the DLA owned material, and potentially a different way as requested by each individual Service owner. SCI expressed dissatisfaction with the Department's current sampling methodologies and believes we should strive for a single standard DoD sampling methodology. Navy in particular was adamant in the view that a single sampling methodology is preferred.

ACTION ITEM 5: DLA and Air Force to provide their current physical inventory sampling plans. DUE: Two weeks from date of final minutes (Oct 20, 2010)

The topic of Opportunities for Early Assessment of E&C Internal Controls was introduced by SCI who explained that they are looking to the Services, Coast Guard and DLA to offer a population of items which they feel would have a clean financial audit if their internal controls were tested in the FY11-FY12 timeframe, e.g., a "quick win". This discussion led to a briefing by the OUSD AT&L/Property, Plant and Equipment (PP&E) Policy office who gave an overview of the Military Equipment "Quick Wins" Existence and Completeness Initiative. Achieving audit readiness for mission critical assets is a priority of the OSD Comptroller and a goal endorsed by USD AT&L. The PP&E office is committed to working with the OSD Comptroller to clarify requirements/definitions and to review E&C plans and test results. The concentration is on assets with high profiles and advanced controls; large dollar value and low density such as aircraft and/or ships. The DON has asserted all ordnance (\$31B) (Navy and Marine Corps) for FY 10. The DON expects to assert all uninstalled Aircraft Engines (\$6B) for FY 11. The Air Force have asserted for E&C Quick Wins on September 30, 2010; the Army and Marine Corps will assert on March 31, 2011. The E&C evaluation will provide Services with a review of their accountability process for mission-critical assets to determine the accuracy and completeness of inventory records, and validation that internal controls are designed and operating efficiently. Findings will be used to develop system requirements and to strengthen policies and procedures.

ACTION ITEM 6: SCI asked each of the Services, Coast Guard and DLA if they would be able to suggest a commodity or target for an early assertion of completeness and existence for FY11. The Navy stated that they would be prepared to assert munitions for FY11. The remaining Components stated they would staff the request and provide submissions within two weeks from date of final minutes. (Oct 20, 2010)

Mr. Paul Peters provided closing comments. He explained that his focus was on achieving results in inventory policy and audit readiness, thanked all attendees for their participation, and asked for their support in moving forward on action items and on more detailed inventory guidance.

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