**Defense Logistics Agency**

# FISCAL YEAR 2018

(Unaudited)

# Agency Financial Report

## Transaction Fund

# DEFENSE LOGISTICS AGENCY TRANSACTION FUND AGENCY FINANCIAL REPORT

DEFENSE LOGISTICS AGENCY
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# Defense Logistics Agency
# Transaction 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 emphasized their 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 Transaction Fund (TF). 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 towards 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

Piled ferromanganese material stored at Point Pleasant, West Virginia depot. Ferromanganese is considered an excess stock and is disposed of through the Sales Program. Revenue generated from sales of excess stock is used to fund stockpile operations from personnel to material acquisitions.

# Management's Discussion and Analysis (Unaudited)

The ***Management's Discussion and Analysis (Unaudited)*** is required supplementary information to the Transaction 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 Transaction Fund mission, goals, objectives, results, and future initiatives to strengthen the Transaction Fund efforts in supporting the Department of Defense objectives and missions.

The ***Analysis of Financial Statements and Stewardship Information*** section provides a summary of the Transaction 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, Statement of Budgetary Resources, and Limitations on 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 Transaction Fund 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. |

The DLA Transaction Fund (TF) employs approximately 80 civilian personnel, where labor is paid from the TF.

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

The following "Who's Who in DLA" chart represents DLA leadership agency directors, J / D Code organizational heads, and the Major Subordinate Command (MSC) heads. The J and D Codes are function areas used within the 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, providing comprehensive, best practice technological Information Technology (IT) support to the DoD/DLA Logistics Business Community, customer support, efficient and economical computing, data management, electronic business, telecommunication services, 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). J6 also manages DLA's Research and Development 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. Additionally, J7 provides the oversight of DLA Strategic Materials (SM).

**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 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 U.S. Army, U.S. Navy, U.S. Air Force and U.S. 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 the 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 of DLA.

**DLA INSTALLATION MANAGEMENT (DM)** provides enterprise-wide Agency policy, program, 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 (EEO) AND DIVERSITY OFFICE (DO)** provides DLA senior leadership, staff and subordinate commands enterprise-wide respondent and subject matter expertise on all 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 (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 the DLA's Enterprise Risk Management (ERM) efforts, and also encompasses external audit projects derived from GAO's high risk list.

## Performance Goals, Objectives, and Results

This Performance Goals, Objectives, and Results section provides a summary of DLA's mission, selected accomplishments, key performance measures, and forward-looking initiatives to strengthen DLA's efforts in achieving a safer and more secure nation. This performance overview encompasses mission activities applicable to the TF. A SM overview and information on funding sources is also provided. DLA's SM group is funded by the TF. Performance Management goals and results relate to the key initiatives that have specific Director's emphasis per DLA's Strategic Plan.

DLA SM is the operational arm of the National Defense Stockpile (NDS). DLA SM's primary responsibility is managerial oversight of the NDS. The NDS is established and governed in accordance with 50 U.S.C. § 98 et seq., The National Defense Stock Piling Act (the Statute). The mission of NDS is to provide for the acquisition and retention of stocks of certain strategic and critical (S&C) materials, to encourage the conservation and development of sources of S&C materials within the United States and thereby decrease and preclude a dangerous and costly dependence upon foreign sources or a single point of failure for supplies of such materials in times of national emergency. Executing the NDS mission by ensuring efficient and responsible resource stewardship and the highest environmental standards is paramount to DLA SM operational goals.

FY2018 saw challenging market conditions for the sales program for disposal of excess NDS stocks. Revenues are generated through competitive public sales of stocks determined excess to the DoD needs. This revenue captured to the NDS TF is the source of funding for operational expenditures and new material acquisitions. The TF is a revolving account created by the Statute to support the operation of the NDS.

The National Defense Authorization Act (NDAA) is the United States Federal law specifying annual budget and expenditures of the U.S. Department of Defense. Over the course of three legislative periods (FYs 2014, 2017, and 2018) Congress authorized, through NDAAs, the National Defense Stockpile (NDS) to begin acquiring stocks of fifteen strategic and critical materials with a dollar value not to exceed $105.0 million. Through the end of FY2018, stocks of nine materials have been entered into the NDS while two additional materials were placed under contract during FY2018. Remaining acquisition authority will continue to be executed in FY2019 and beyond.


**Figure 2, Lines of Effort and Objectives**

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

**<u>LOE #1: Warfighter First</u>**

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. DLA continues to provide world-class support and strategies aligned with DoD priorities, operational readiness concerns, and weapon system product support with a solid understanding of the impact to our Warfighters and a targeted solutions-based response.

DLA SM maintains the NDS, a stockpile of S&C materials suitable for the Defense industrial base. Annually SM requests authority for S&C material acquisitions in accordance with requirements planning. SM also reviews S&C materials within the NDS to ensure quality and form synchronize with current and future needs of the Warfighters and DoD. In support of this goal, DLA SM continued material acquisitions and upgrade programs during FY2018. Additionally, to sustain defense capabilities, NDS materials excess to requirements due to industry or technological changes may be offered for sale in accordance with the Statute. Proceeds are transferred to the TF to provide resources to fund operations and acquisitions.

**Strategic & Critical Material Acquisition Values**

The S&C Material Acquisition Value measure maintains NDS inventory aligned to requirements. This ensures S&C materials are available to mitigate defense supply risks during national emergencies.

**Strategic & Critical Material Upgrade Tin Re-melt**

The S&C Material Upgrade Tin Re-melt measure is a joint project with Rock Island Arsenal (U.S. Army), for re-melt reprocessing of tin. This effort improves the quality and grade of reprocessed tin, better suited for future DoD applications in a form more stable for long-term storage.

**Sales Awards Dedicated to the National Defense Stockpile Program**

The Sales Awards Dedicated to the NDS Program measure looks at sales proceeds into the TF to provide resources for operations and acquisitions. Converting excess material to budgetary resources reduces cost to taxpayers.

**LOE #2: Global Posture**

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

DLA SM mission is to ensure S&C materials are readily available in a time of national emergency, this aligns to DLA's LOE "Global Posture."

The NDS provides immediate access to S&C materials needed for the DoD in a time of national emergency or conflict. The S&C materials needed to reconstitute that which is expended in the conflict are stockpiled for immediate use—materials otherwise not readily available in the United States. Stockpiling S&C materials and maintaining them at the ready is what DLA SM does.

**LOE #3: Strong Partnerships**

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

DLA SM is executing its statutory authority to recover and recycle valuable SM otherwise lost to demilitarization and disposal. Through the Strategic Materials Recovery and Recycling Program, DLA SM has collaborated with DLA Disposition and DLA Distribution to identify, recover and relocate to DLA SM Depots valuable materials with additional usefulness to the DoD. DLA SM regularly engages with industry metal markets to support the NDS Sales Program, which disposes of excess materials. DLA SM has over four decades of market interaction as a trusted supplier of minerals and metals. DLA SM has built strong partnerships with industry that provide valuable and current market intelligence. This market intelligence, along with industry partnerships is transferrable to the successful acquisition efforts of the NDS building competition, which directly promote the best practices for future purchases of S&C stockpile materials.

**LOE #4: Whole of Government**

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

FY2018 highlighted our continuous commitment toward increasing efficiency and effectiveness in our service to all DoD stakeholders. In FY2018, DLA SM continued executing authority granted in the FY2014 NDAA for the recycling and recovery of S&C materials from government sources. Germanium and various high-grade cobalt, nickel and titanium-bearing alloys were recovered to the NDS. These materials are now stored at DLA SM inventory locations and are available to mitigate critical material shortfalls.

The Germanium Recycling Project is a WoG initiative for DLA SM. Germanium is used either as metal or in combination with other transparent materials to construct night-vision and thermal targeting systems, used in aircraft targeting pods and land vehicles. As components are reconditioned and withdrawn from service, germanium has been accumulating at various military installations. Although germanium is a critical material that should not be discarded, a viable recovery process does not exist. Joint recycling partnerships have been formed with the U.S. Army, the U.S. Navy, and the U.S. Air Force to address this. Components are disassembled and demilitarized, germanium is recovered, and radioactive thorium optical coatings are removed (under a Nuclear Regulatory Commission license). After confirmation, items are surveyed, packaged and shipped to a NDS depot for long-term storage.

The Strategic Materials Recycle and Recovery Program is another WoG Initiative for DLA SM. Super-alloys are used in jet turbine engines, such as the F-16 engine. Prior practice has been to demilitarize and dispose of these alloy parts using public auction services such as Government Liquidators. As DLA became aware of the loss of SM through this process, hot engine parts were held back and are now recovered via joint recycling partnerships. With participants from DLA Distribution, DLA Disposition Services, and the U.S. Air Force, process improvements continue to be made, and the overall program efficiency continues to improve.

**LOE #5: Always Accountable**

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.

In FY2018, DLA SM executed the following in support of the Always Accountable LOE:

1. Developing Corrective Action Plans to address DLA's material weaknesses and internal control findings.
2. Reduce costs by managing excess stockpile material sales to create opportunities for reducing lease costs at unmanned storage locations.

**LOE #6: People and Culture**

DLA is a dynamic organization and our workforce is our greatest asset. To this end, 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. In FY2018, DLA SM achieved the following:

- Completed the first year of the DoD Performance Management and Appraisal Program for all DLA SM employees.
- Continued monthly Employee Appreciation Awards to extend the organization's gratitude to employees who have gone above and beyond in their job performance.
- Continued DLA SM monthly Employee Appreciation Meetings to communicate issues of importance throughout the organization, increase employee morale, and congratulate Employee Appreciation Award winners.
- Executed a one day Managers Meeting and for all HQ and Depot managers.
- Ensured all processes and procedures were followed in the hiring process.

**LOE #7: Enterprise Enablers**

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.

In FY2018, DLA SM leveraged its Mercury Transfer and Long Term Storage program in fulfillment of the Enterprise Enablers LOE to achieve the following:

**Mercury Transfer and Long Term Storage Program:**

DLA SM maintains a large stockpile of high-grade mercury. Mercury is a potent neurotoxin with a wide range of well-documented impacts to human health, wildlife, and the environment. The mercury inventory, consolidated at Hawthorne, Nevada, has been undergoing a multi-year repackaging effort.

**Strategic Material Funding Sources**

DLA SM is financed through a revolving account known as the Transaction Fund (TF). The funding is provided on an annual basis through an OMB apportionment of TF resources. As of September 30, 2018, the TF FBwT is $294 million. The NDSTF is referred to as the Transaction Fund and provides funding for SM. Congress approves the operational budget and funds the TF annually via the NDAA. Additionally, the NDS contains approximately $1.1 billion in assets at current fair market value. Under the Statute, the TF provides on-going funding for the operation of the NDS as funds are replenished through the sale of excess stocks.

The TF faces a longer-term problem funding operating costs and procuring sufficient material to satisfy requirements outlined in the Annual Materials Plan. Per the Statute, DLA SM delivered to Congress, "The Strategic and Critical Materials Report on Stockpile Requirements" on January 15, 2017. This is referred to as the "Requirements Report." This biannual report informs Congress and the DoD of S&C material candidates for stockpiling. The Requirements Report provides insight into supply chain vulnerabilities and potential materials shortfalls under approved national emergency planning scenarios. In FY2018, there was considerable effort in compiling the FY2019 Requirements Report, which is due to Congress on January 15, 2019.

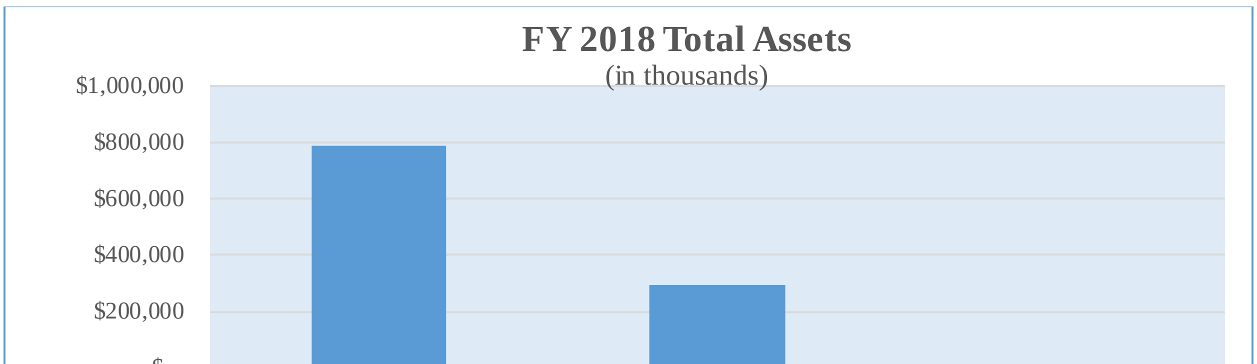
# Analysis of Financial Statements and Stewardship Information

The Financial Statements presented in this AFR relate solely to DLA's TF. The Financial Statements for Working Capital Fund (WCF) and General Fund (GF) are located in their respective AFRs. The DLA SM budgetary resources were approximately $279.2 million for FY2018. DLA prepares its Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position 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 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 Statement of Budgetary Resources.

## Balance Sheet

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

## Assets – What We Own and Manage




| | Stockpile Material | Fund Balance with Treasury | Other Assets |
|---|---|---|---|
| FY 2018 | $785,841 | $294,139 | $1,507 |

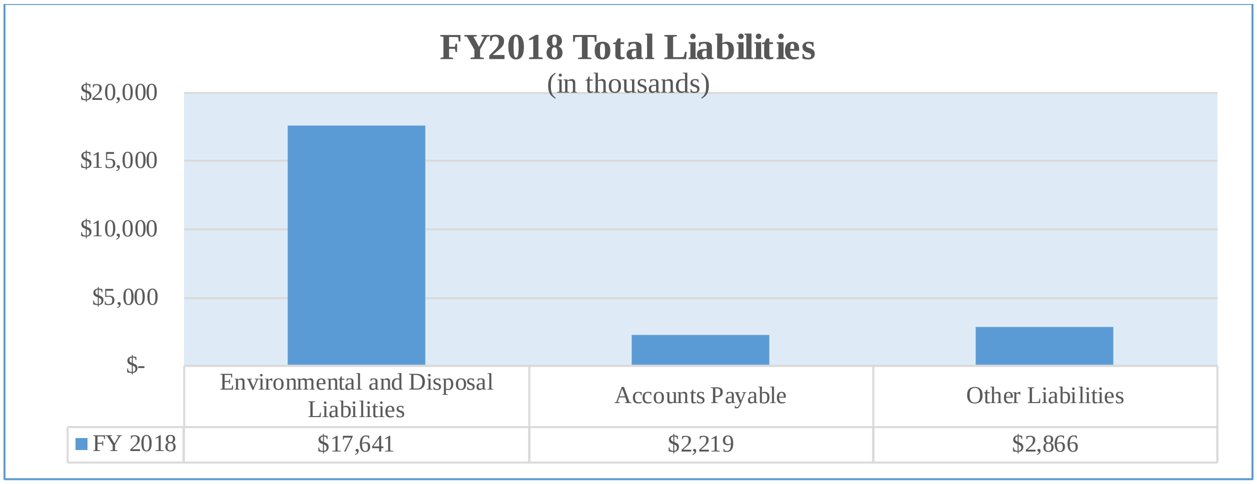
Assets represent amounts owned or managed by DLA that can be used to accomplish its mission. As of September 30, 2018, the TF had $1.1 billion in assets.

*Stockpile Material, Net* is the SM's largest asset that comprises 72.7% of total assets. Inventory balances consists of Stockpile Materials which are S&C materials held due to statutory requirements for use in national defense, conservation, or national emergencies.

*Fund Balance with Treasury (FBwT)* is the second largest asset, comprising 27.2% of total assets.

Other Assets represent less than 1.0% of total assets, which includes *General Property, Plant, and Equipment, Net*, and *Accounts Receivable, Net*.

## Liabilities – What We Owe




As of September 30, 2018, the TF reported approximately $22.7 million in total liabilities of which $11.4 million are liabilities not covered by budgetary resources.

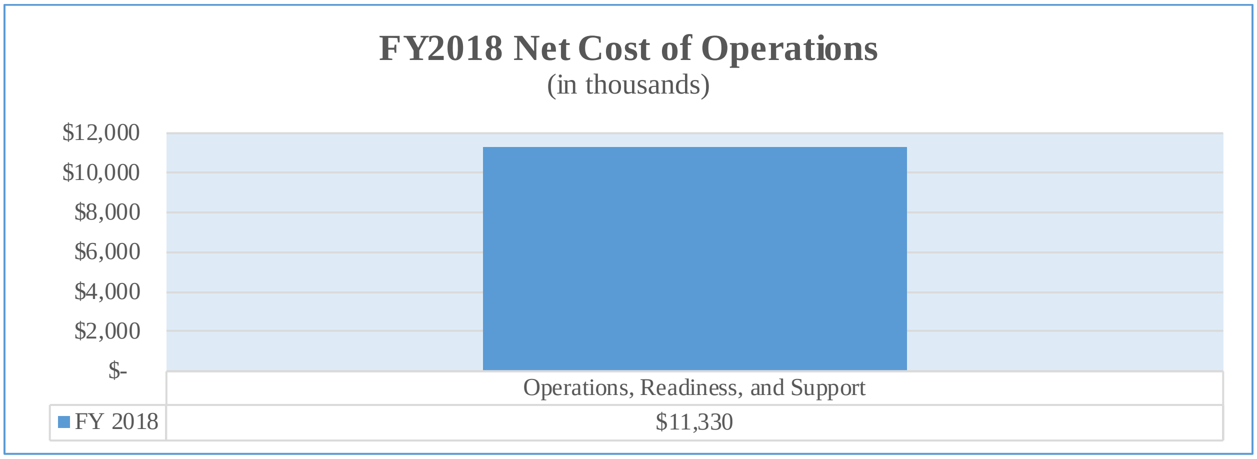
The DLA's largest liability is for *Environmental and Disposal Liabilities*, representing 77.6% of total liabilities. The DLA TF is responsible for clean-up requirements of Non-Base Realignment and Closure (Non-BRAC) Installations in which they have conducted past or present operations.

*Accounts Payable* represents 9.8% of total liabilities, and results from amounts owed to other Federal agencies and the public for goods and services received by DLA.

*Other liabilities* represents 12.6% of the TF's liabilities, includes *Other Liabilities* and *Other Federal Employment Benefits*.

## Statement of Net Cost

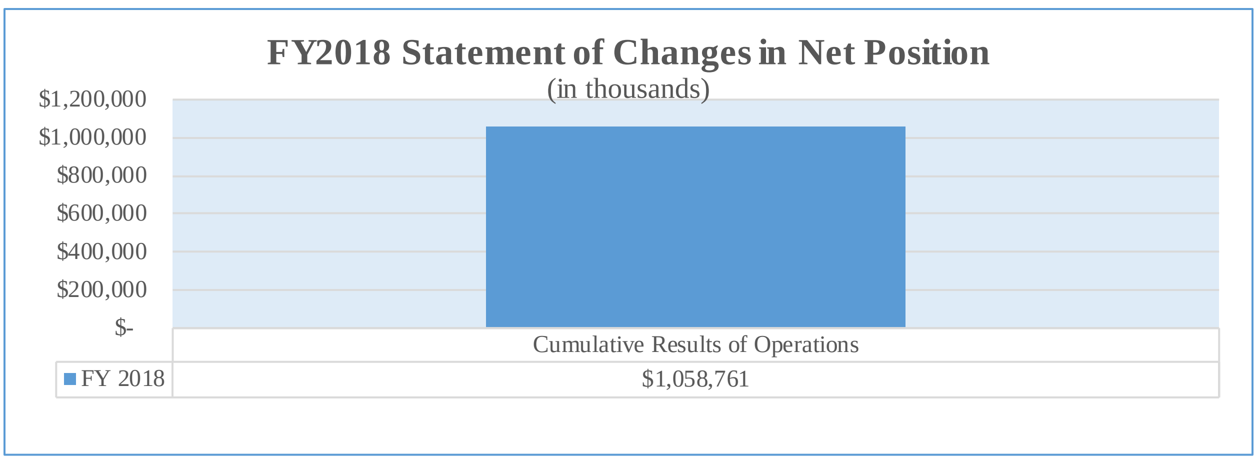
The Statement of Net Cost (SNC) of operations represents the difference between the costs incurred and revenue earned by TF programs. The DLA TF SNC is reported in one segment: Operations, Readiness, and Support.




In FY2018, the DLA TF reported approximately $11.3 million in net cost of operations. During FY2018, the DLA TF earned approximately $44.7 million in exchange revenue. Exchange revenue arises from transactions in which DLA provides goods and services to the public.

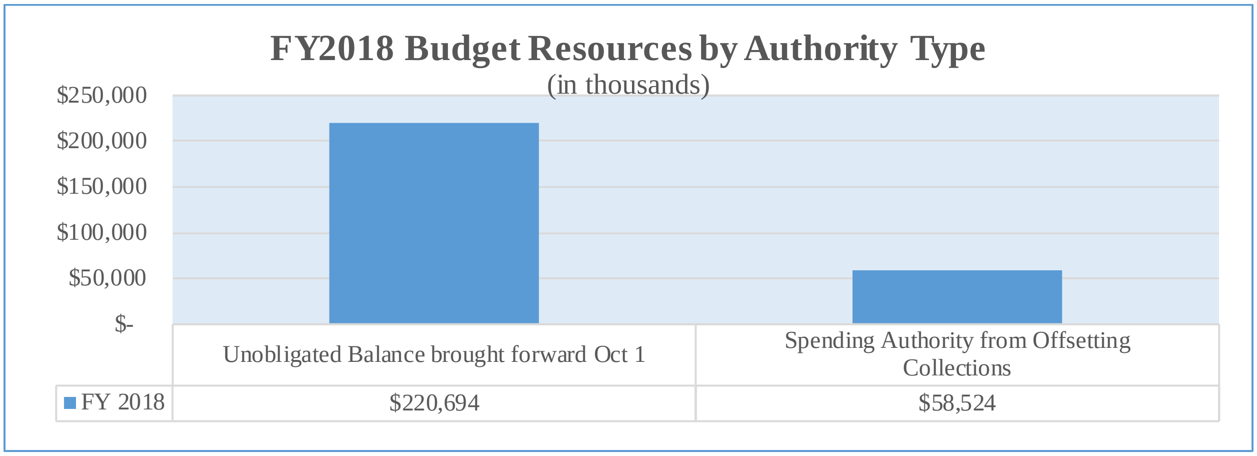
### Statement of Changes in Net Position

The Statement of Changes in Net Position (SCNP) consists of Cumulative Results of Operations, which represents the accumulation of revenue, expenses, and other financing sources since inception. The SCNP presents changes to the DLA TF's net position during the year. Financing sources increase net position and include, but are not limited to, appropriations and user fees. The net costs discussed in the section above decrease net position. Total net position is $1.1 billion.




### Statement of Budgetary Resources

The Statement of Budgetary Resources (SBR) provides information on the status of the approximately $279.2 million in budgetary resources available to the DLA TF during FY2018.




The authority was primarily derived from $220.7 million in authority carried forward from FY2017 and $58.5 million in Spending Authority from Offsetting Collections.

As of September 30, 2018, $224.6 million of the $279.2 million was not yet obligated. The $224.6 million represents unapportioned and unexpired funds. Of the total budget authority available, the DLA incurred a total of $54.6 million 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 TF, 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 A-136, *Financial Reporting Requirements*. At times, the DLA is unable to implement all elements of the standards due to financial management systems limitations. The 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 DLA TF 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 TF is unable to fully prepare the financial statements in conformity with U.S. 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 control 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 the 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 Transaction Fund

As Director, 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.

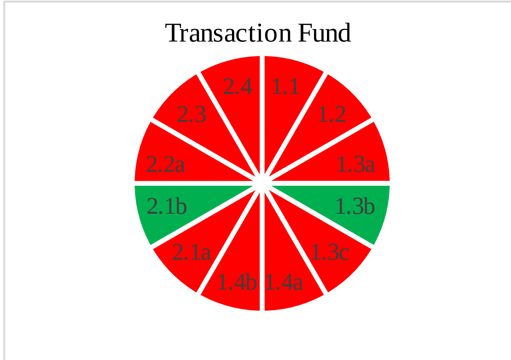
- Federal Financial Management System Requirements (FFMSRs),
- Applicable Federal accounting standards, and
- The U.S. Standard General Ledger (USSGL) at the transaction level.

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 aligned to the associated TFM FFMSRs and goals 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 ADA 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. Ten of the twelve indicators for the TF 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 reasonable 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

The 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 TF notifies all appropriate authorities of any potential ADA violations. There are no known or potential ADA violations at this time.

DLA's TF 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 TF 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 U.S. 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, Internal Documents (IDOCs), customer/vendor master, financial hierarchy (Fund, Fund Center, General Ledger Account Code (GLAC), 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 TF 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 workforce.

The changing demographics is the first significant external factor. There are different generations working side-by-side in the DLA workplace. DLA civilians are playing an increasingly more critical role in supporting global DoD missions. These changing demographics will require continued assessments of our current initiatives and new strategies in areas such as recruitment, training and development, work-life balance, and managing personnel 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 workforce works, plays, and interact with others. It is important to empower the workforce through technology to meet changing mission requirements. It is paramount for DLA to develop innovative Human Capital management strategies to recruit, develop, and sustain a workforce that is technically proficient and agile as they adapt to emerging technologies.

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

DLA continuously identifies and reviews risks and develops mitigation strategies for the NDSTF and essential civilian industrial materials. DLA developed a 2018-2024 SM Program and Budget Submission that was submitted in September 2018. The purpose of this plan is to provide funding to ensure conservation and supply of S&C materials within the United States to mitigate dangerous and costly dependence upon foreign or single sources of supply in times of national emergency.

DLA SM continues to work closely in developing skill gaps and empowering the agency to continue to carry out its mission. To emphasize the labor plan, budget projections are set through FY2020 with means for best staffing levels to achieve program objectives and prevent external threats. Most importantly, DLA SM will continue to mitigate S&C material supply risks through responsible management of NDS material inventory, qualification of substitute materials, recycling and acquisition of S&C materials.

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.

## Technology Advancement and Initiatives

DLA Finance is working on two major system initiatives that affect the TF fund. G-Invoice is a Treasury mandated process to improve the reconciliation and coordination of intra-governmental payments. Second, the implementation of the DoD Standard Line of Accounting will improve the interoperability between DoD business systems and provide better end-to-end funds traceability and eliminations reporting to enable successful audits in DoD.


Re-melted Tin ingots stored at Hammond, Indiana depot. This re-melt project has increased the quality and grade of tin held in the NDS to be more suitable for any future needs of the tin inventory.

## Financial Section (Unaudited)

The Financial Section (Unaudited) demonstrates our commitment to effective stewardship over the Transaction Fund. DLA receives funding for the Transaction Fund to carry out its mission, including compliance with relevant financial management legislation. It includes the Transaction Fund **Financial Statements**: the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Budgetary Resources, as well as the accompanying **Notes to the Financial Statements.** It also includes the **Independent Auditors' Report** on the DLA's Transaction 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 Transaction Fund (TF) financial activities.

DLA received a Disclaimer of Opinion on the Agency's TF 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 from financial statement audits, enhancing the reliability of financial statement data, and ensuring the accounting process and related controls document approved policies. For the TF, we have enhanced our controls surrounding Information Technology General Controls, and Inventory.

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 CFO 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, *Financial Reporting Requirements*, as amended. 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 the DLA's TF principal financial statements. The Independent Auditors' Report accompanies the principal financial statements. 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 TF 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 **Statement of Budgetary Resources** presents how and in what amounts budgetary resources were made available to the DLA during FY2018, 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 - Transaction Fund**
**Balance Sheet**
**As of September 30, 2018**
**(In Thousands)**

| | | Unaudited 2018 |
|---|---|---|
| **ASSETS** | | |
| **Intragovernmental** | | |
| Fund Balance with Treasury (Note 2) | $ | 294,139 |
| **Total Intragovernmental Assets** | **$** | **294,139** |
| Accounts Receivable, Net | | 43 |
| Stockpile Material, Net (Note 3) | | 785,841 |
| General Property, Plant, and Equipment, Net (Note 4) | | 1,464 |
| **TOTAL ASSETS** | **$** | **1,081,487** |
| **LIABILITIES** | | |
| **Intragovernmental:** | | |
| Accounts Payable | $ | 533 |
| Other Liabilities (Note 8) | | 274 |
| **Total Intragovernmental Liabilities** | **$** | **807** |
| Accounts Payable | | 1,686 |
| Environmental and Disposal Liabilities (Note 7) | | 17,641 |
| Other Liabilities (Note 8) | | 847 |
| Other Federal Employee Benefits (Note 6) | | 1,745 |
| **TOTAL LIABILITIES (Note 5)** | **$** | **22,726** |
| **COMMITMENTS AND CONTINGENCIES** | | |
| **NET POSITION** | | |
| Cumulative Results of Operations | | 1,058,761 |
| **TOTAL NET POSITION** | **$** | **1,058,761** |
| **TOTAL LIABILITIES AND NET POSITION** | **$** | **1,081,487** |

The accompanying notes are an integral part of these statements.

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

| | Unaudited 2018 |
|---|---|
| **Gross Program Costs** | |
| **Operations, Readiness & Support** | |
| Gross Cost | $ 55,988 |
| Less Revenue Earned | (44,658) |
| **Net Cost** | 11,330 |
| **NET COST OF OPERATIONS** | **$ 11,330** |

The accompanying notes are an integral part of these statements.

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

| | Unaudited 2018 |
|---|---|
| **Cumulative Results of Operations** | |
| Beginning balances | $ 1,069,560 |
| | |
| **Other Financing Sources:** | |
| Imputed financing from costs absorbed by others | 531 |
| Total Financing Sources | 531 |
| Net Cost of Operations | 11,330 |
| **Net Change** | **(10,799)** |
| **Cumulative Results of Operations** | 1,058,761 |
| **Net Position** | **$ 1,058,761** |

The accompanying notes are an integral part of these statements.

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

| | | Unaudited 2018 |
|---|---|---|
| **BUDGETARY RESOURCES** | | |
| Unobligated Balance Brought Forward, October 1 | $ | 220,694 |
| Unobligated Balance From Prior Year Budget Authority, Net | $ | 220,694 |
| Spending Authority From Offsetting Collections | | 58,524 |
| **TOTAL BUDGETARY RESOURCES** | **$** | **279,218** |
| | | |
| **Memorandum (non-add) entries:** | | |
| Net adjustments to unobligated balance brought forward, Oct 1 | **$** | **1,877** |
| **STATUS OF BUDGETARY RESOURCES** | | |
| New Obligations and Upward Adjustments | $ | 54,614 |
| Unobligated Balance, End of Year: | | |
| Unapportioned, unexpired accounts | | 224,604 |
| Total Unobligated Balance, End of Year | | 224,604 |
| | | |
| **TOTAL BUDGETARY RESOURCES** | **$** | **279,218** |
| | | |
| **OUTLAYS, NET** | | |
| Outlays, net | $ | (21,018) |
| **Agency Outlays, Net** | **$** | **(21,018)** |

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

The National Defense Stockpile (NDS) is composed of strategic and critical (S&C) materials authorized for use during times of national emergencies. By Executive Order 12626, the Secretary of Defense is designated as the NDS Manager. The Secretary of Defense delegated the management responsibilities to the Office of the Under Secretary of Defense (OUSD) for Acquisition and Sustainment through the Assistant Secretary of Defense for Sustainment. The operational activities of the NDS are delegated to the Director of the DLA. The Defense Finance and Accounting Service (DFAS) provides accounting and transaction processing services.

The DLA Strategic Materials program is a separate revolving fund which operates under the authority of the Strategic and Critical Materials Stock Piling Act (50 United States Code (U.S.C.) §98, et seq.). Under the Act, critical materials are stockpiled in the interest of national defense to preclude a dangerous and/or costly dependence upon foreign or single source suppliers in. DLA Strategic Materials' Stockpile Manager administers the acquisition, storage, management, and disposal of the stockpile. The 2018 National Defense Authorization Act authorized the Stockpile Manager to acquire materials determined to be strategic and critical to meet defense, industrial, and essential civilian needs of the United States. The legislation further provided authority to dispose of certain materials, with proceeds deposited in the Fund to finance future Stockpile operating costs and procurement of replenishment materials.

Examples of S&C Materials includes:

- Ores
- Metals
- Alloys
- Chemicals
- High-Performance Fibers
- Energetics

### 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 are presented in the format prescribed by the Office of Management and Budget (OMB) in 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 budgetary resources of the DLA TF, as required by the Chief Financial Officers Act of 1990, as amended and the Government Management Reform Act of 1994.

The DLA TF financial statements have been prepared from the accounting records of DLA TF, and do not include the DLA GF or WCF, 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.

DLA TF is unable to fully prepare these financial statements in conformity with U.S. GAAP due to limitations of the financial and nonfinancial management systems and processes that currently support DLA TF 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 actions required to bring its financial and nonfinancial systems and processes into compliance with U.S. GAAP. Until all DLA financial and nonfinancial feeder systems and processes are able to collect and report financial information as required by U.S. GAAP, DLA continues to implement interim mitigating processes to address these limitations. In addition, DLA is remediating deficiencies pertaining to reconciliations and adequacy of the supporting documentation identified through audits and other compliance reporting.

Currently, DLA TF identified the following non-U.S. GAAP accounting practices or policies that affect the DLA TF financial statements:

- Financial Statements – DLA does not present comparative financial statements due to the identification of non-U.S. GAAP accounting practices or policies.
- Accounts Payable – A 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.
- Stockpile Material - The accounting for the sale of stockpile materials does not comply with the Treasury Financial Manual United States Standard General Ledger. The difference between the sales contract and book value, whether a gain or loss, is recorded in the gain account. The gain and loss should be recorded in separate accounts.
- Leases – DLA does not currently report capital and operating leases in its financial statements (see Note 1.H.)
- Undelivered Orders - DLA does not have the proper policy and procedures to reconcile the Undelivered Orders from the EBS trial balance to the transaction detail.
- 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.D).

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. 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. Budgetary accounting facilitates compliance with legal constraints and the controls over the use of Federal funds. The 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 TF 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 TF did not make an unreserved assertion in the application of SFFAS 48 (see Note 3).

## D. Fund Balance with Treasury

The DLA TF does not maintain cash in a commercial bank account, but rather in U.S. Treasury Account. The balance in the Treasury Account represents the aggregate amount available for DLA to pay current liabilities and finance authorized purchases, except as restricted by law. DLA uses suspense accounts to hold transactions temporarily pending clearance to the correct appropriation. The transactions in suspense accounts include unidentified collections, disbursements and Intra-Governmental Payment and Collection Transactions at month end.

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 Treasury Account Symbol (TAS). The Defense Finance and Accounting Service (DFAS) Disbursing Office in Columbus, Ohio processes cash collections, disbursements, and adjustments. The U.S. Treasury records transactions affecting the NDSTF Fund Balance with Treasury (FBwT) account. On a monthly basis, the NDSTF FBwT balance is reviewed and adjusted to agree with the U.S. Treasury accounts.

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 Treasury Account Symbol information.

DLA adjusts its FBwT account balance to 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 DFAS-IN and provides summary cash position for all Defense Agencies in the 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 which compares transactions recorded between CMR and the accounting system of record, and reports the undistributed disbursement and collection variances.

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.

## E. Accounts Receivable, Net

Accounts Receivable consists of sales offerings to customers who have been prequalified by DLA to purchase material in a particular offering. The basic ordering agreements for all material require customer payment within the contract period, typically 30 days, and generally prior to the shipment of materials. The existing accounts receivable balance is current. The DLA TF generally does not have uncollectable receivables and therefore, does not establish an Allowance for Doubtful Accounts.

## F. Stockpile Material

The DLA TF has two classifications of stockpile materials as described below:

Stockpile Materials Held in Reserve for Future Use: This Stockpile Material is comprised of S&C Materials held due to statutory requirements for use in national defense, conservation or national emergencies. They are not held with the intent of selling in the ordinary course of business.

Stockpile Materials Held For Sale: This Stockpile Material is comprised of Ores, Metals, Alloys, Chemicals, High-Performance Fibers, and Energetics authorized for sale. The materials authorized for sale is valued using the same basis used before they were authorized for sale. Any gain (or loss) upon sale must be recognized as a gain (or loss) at that time.

Both stockpile material classifications are valued at historical cost, also known as Actual cost (AC). Lower of cost or market valuation is used when AC is lower than market value.

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

- Accurate recording of inventory quantities in the proper period.
- Inventory valuation process.
- Existence and completeness of inventory.

## G. General Property, Plant and Equipment

DLA TF General Property, Plant & Equipment (PP&E) consists of general equipment used to facilitate the Agency's mission. DLA uses the straight-line method to calculate and accumulate depreciation expenses. The straight-line method is based on the acquisition cost and depreciated over the asset's useful life.

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

DLA TF also capitalizes improvements added to existing General PP&E assets, if the improvements equal or exceed the capitalization threshold, extend the useful life or increase the size, efficiency, or capacity of the asset.

## H. 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.*

## I. 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.

## J. 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 TF estimates and records accruals based on actual invoices received (i.e. transportation service). The accounts payable methodology is a non-U.S. GAAP accounting practice or policy.

## K. 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 does not record an accrual for contingent liabilities if it is not probable and estimable, but does disclose those contingencies that are reasonably possible 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. DLA TF does not have any contingent liabilities that are reasonably possible or probable.

## L. 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 5).

Unearned revenue is recorded when the DLA receives payment for goods or services which have not been fully rendered. As such receipt of payments in advance of providing goods and services are reported as other liabilities on the Balance Sheet.

## M. Environmental Liabilities

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 through its annual Cost-to-Complete process. DLA's accrued Environmental Liabilities 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 (see Note 7).

## N. Payroll and Annual Leave Accruals

Accrued payroll consists of salaries, wages, and other compensation earned by employees, but not yet disbursed. 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.

## O. Federal Employment 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 who are injured on the job or have occupational illness. FECA also provides survivor's benefit for employees whose death is attributable to a job-related injury or occupational illness. DOL bills DLA annually as claims are paid, and 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 DLA terminates without cause may receive unemployment compensation benefits under the unemployment insurance program also administered by DOL, who bills each agency quarterly for paid claims.

## P. Pension Benefits

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.

## Q. Net Position

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

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.

## R. Revenue and Other Financing Sources

DLA TF receives annual apportionments from OMB to finance acquisition of stockpile materials. The DLA TF also receives Anticipated Collections from Non-Federal Sources Authority to sell the materials that have been deemed excess to the needs of the Stockpile. The proceeds from the sale of materials are DLA's TF major financing source and are used to fund the operation. In addition, material are offered for sales on the open market and are awarded through competitive bidding.

The DLA recognizes the costs incurred by the DLA but financed by other entities on behalf of the DLA as imputed financing. The DLA TF recognizes the following imputed costs: (1) employee pension, post-retirement health, and life insurance benefits and (2) post-employment benefits for terminated and inactive employees to include workers compensation under the FECA.

## S. 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. The DLA TF uses estimates for environmental liabilities. The actual result from the reported amounts and expenses during the reporting period may differ from these estimates.

## Note 2. Fund Balance with Treasury - Unaudited

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

| | 2018 |
|---|---|
| **Status of Fund Balance with Treasury** | |
| **Unobligated** | |
| Unavailable | $ 250,201 |
| **Obligated Balance not yet Disbursed** | 43,938 |
| **Total** | $ 294,139 |

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. As of September 30, 2018, DLA TF does not have unobligated – available FBwT.

Unobligated Balance - unavailable represents the cumulative amount of budgetary authority that cannot be used to cover outstanding obligations.

Obligated Balance not yet Disbursed represents funds obligated for goods and services not received, and those received but not paid.

As of September 30, 2018, DLA TF does not have non-budgetary FBwT.

## Note 3. Stockpile Material, Net - Unaudited

Stockpile Material, Net at September 30, 2018, consists of the following (in thousands):

| | 2018 | |
|---|---|---|
| | Stockpile Material, Net | Valuation Method |
| **Stockpile Material Categories** | | |
| Held for Sale | $ 32,084 | AC, LCM |
| Held in Reserve for Future Use | 753,757 | AC, LCM |
| **Total** | $ 785,841 | |

**Legend for Valuation Methods**

AC = Actual Cost LCM = Lower of Cost or Market

Inventory held for sale estimated market value is $33.8 million at September 30, 2018. Held for sale material is designated based on the annual sales forecast.

## Note 4. General Property, Plant, and Equipment, Net - Unaudited

General Property, Plant, and Equipment, Net at 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** | | | | | |
| General Equipment | S/L | 5 or 10 | $ 2,337 | $ (873) | $ 1,464 |
| **Total General PP&E** | | | $ 2,337 | $ (873) | $ 1,464 |

**Legend for Valuation Methods:**

S/L = Straight Line

## Note 5. Liabilities not covered by Budgetary Resources - Unaudited

Liabilities Not Covered By Budgetary Resources, Net at September 30, 2018, consists of the following (in thousands):

| | | 2018 |
|---|---|---|
| **Intragovernmental Liabilities** | | |
| Other | $ | 202 |
| **Total Intragovernmental Liabilities** | $ | 202 |
| | | |
| **Non-Federal Liabilities** | | |
| Other Federal Employment Benefits | | 1,745 |
| Environmental and Disposal Liabilities | | 8,800 |
| Other Liabilities | | 645 |
| **Total Non-Federal Liabilities** | $ | 11,190 |
| | | |
| **Total Liabilities Not Covered by Budgetary Resources** | $ | 11,392 |
| | | |
| **Total Liabilities Covered by Budgetary Resources** | | 11,334 |
| | | |
| **Total Liabilities** | $ | 22,726 |

The note above includes the following categories of liabilities:

Intragovernmental Liabilities, Other consists of accruals for current year Federal Employment Compensation Act (FECA) Liability based on DOL records.

Non-Federal Liabilities Other consists of unfunded annual leave owed to civilian employees. This category does not cover Federal employees.

Liabilities Not Covered by Budgetary Resources include items such as certain environmental and disposal liabilities, annual leave, and workers' compensation under FECA.

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

## Note 6. Other Federal Employment Benefits - Unaudited

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

| | 2018 | |
|---|---|---|
| | Liabilities | Unfunded Liabilities |
| **Other Benefits** | | |
| Federal Employees Compensation Act (FECA) | $ 1,745 | $ 1,745 |
| Total Other Benefits | 1,745 | 1,745 |
| **Total Other Federal Employment Benefits:** | $ 1,745 | $ 1,745 |

**Actuarial Calculations**

The DLA actuarial liability for workers' compensation benefits is developed by the DOL Office of Workers' Compensation Programs 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 OMB's 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 7. Environmental and Disposal Liabilities - Unaudited

Environmental and Disposal Liabilities at September 30, 2018, consists of the following (in thousands):

| | | 2018 |
|---|---|---|
| **Environmental Liabilities-Non-Federal** | | |
| Environmental Corrective Action | $ | 17,588 |
| Enviromental Closure Requirements | | 53 |
| **Total Environmental Liabilities** | $ | 17,641 |

The DLA's TF's Environmental Liabilities (EL) are comprised of two primary elements: (1) existing obligations supporting TF environmental restoration programs, and (2) anticipated future cost necessary to complete the environmental restoration requirements at DLA SM environmental sites.

In FY2018, DLA utilized Version 11.4 of the Remedial Action Cost Engineering & Requirements (RACER) software to generate the FY2019 Cost to Complete (CTC) estimates of anticipated future costs. Cost estimates related to environmental sites under Strategic Materials management were generated for seven Non-BRAC Corrective Action sites and seven Non-BRAC Closure sites.

**Applicable Laws and Regulations for Cleanup Requirements**

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; the Superfund Amendments and Reauthorization Act; the Resource Conservation and Recovery Act (RCRA); the Clean Water Act; and other applicable Federal, State, interstate, local laws, and regulations. Required clean up may at times extend beyond Installation boundaries onto privately owned property, and onto sites where DLA is named as a potentially responsible party by a regulatory agency.

**Types of Environmental Liabilities and Disposal Liabilities**
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 restoration activities and operations, and closure and disposal of facilities and equipment. All cleanup is conducted in coordination with regulatory agencies, other responsible parties, and current property owners. Types of Transaction Fund Other Accrued EL – Non-BRAC include:

- Environmental Corrective Action – EL associated with the cleanup sites not eligible for funding under the Defense Environmental Restoration Program (DERP), 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.

**Methods for Assigning Estimated Total Cleanup Costs to Current Operating Periods**
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 in accordance with Department of Defense (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 cost estimates from the prior year CTC can be attributed to the increase in Non-BRAC Corrective Actions primarily due to the addition of the DNSC Somerville Area of Concern site to the CTC. This site was previously tracked through the EL Site Identification (ID) process as a potential EL as out-year requirements were unknown; however, in FY2018, out-year requirements were determined to be known and estimable due to the availability of results from the Remedial Design Investigation and Feasibility Study. Year-to-year fluctuations in DLA TF's ELs are expected due to changes in agreements with regulatory agencies, deflation, inflation, and technology. The latest version of RACER was used to prepare the estimates which reflected a FY2017 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.

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 there were no material changes to DLA TF EL between the time the original CTC estimates were approved and finalized and September 30, 2018. The Roll Forward process is conducted in accordance with the DLA EL CTC Standard Operating Procedure (SOP), the DoD 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 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, an environmental event was identified as a Potential Out-Year EL due to ongoing and unresolved legal actions. This site will be re-evaluated during the next Site ID process to determine if any changes have taken place and sufficient information/data are available to create an estimate that would be included in the TF EL balance.

**Unrecognized Costs**

The DLA systematically recognizes Closure liabilities over the useful life of assets in accordance with DoD FMR Volume 4, Chapter 13, Paragraph 130203 (April 2018). The total recognized Closure liability is stated above in the footnote and the unrecognized Closure liability is $2,053. 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.

## Note 8. Other Liabilities - Unaudited

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

| | 2018 | | |
|---|---|---|---|
| | Current Other Liabilities | Noncurrent Other Liabilities | Total Other Liabilities |
| **Intragovernmental** | | | |
| FECA Reimbursement to the Department of Labor | $ 40 | $ 162 | $ 202 |
| Employer Contribution and Payroll Taxes Payable | 72 | - | 72 |
| Total Intragovernmental Other Liabilities | $ 112 | $ 162 | $ 274 |
| **Non-Federal** | | | |
| Accrued Funded Payroll and Benefits | $ 202 | $ - | $ 202 |
| Accrued Unfunded Annual Leave | 645 | - | 645 |
| Total Non-Federal Other Liabilities | 847 | - | 847 |
| **Total Other Liabilities** | $ 959 | $ 162 | $ 1,121 |

## Note 9. 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 TF only had Reimbursable Obligations Incurred 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 (in thousands):

| | Category B |
|---|---|
| Direct Obligations Incurred | $ - |
| Reimbursable Obligations Incurred | 54,614 |
| Total | **$ 54,614** |

## Note 10. Undelivered Orders at the End of the Period - Unaudited

Undelivered Orders at September 30, 2018 (in thousands):

| | 2018 |
|---|---|
| **Intragovernmental** | |
| Unpaid | $ 10,016 |
| Total Intragovernmental | 10,016 |
| **Non-Federal** | |
| Unpaid | 31,430 |
| Total Non-Federal | 31,430 |
| **Total Undelivered Orders** | $ 41,446 |

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 TF does not have paid intragovernmental and Non-Federal undelivered orders.

## Note 11. 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 | $ | 54,614 |
| Less: Spending authority from offsetting collections and recoveries | | (67,497) |
| Obligations net of offsetting collections and recoveries | | (12,883) |
| Net obligations | $ | (12,883) |
| **Other Resources:** | | |
| Imputed financing from costs absorbed by others | $ | 531 |
| Net other resources used to finance activities | | 531 |
| **Total resources used to finance activities** | $ | (12,352) |
| **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 | $ | (8,525) |
| Resources that finance the acquisition of assets | | (4,111) |
| **Total resources used to finance items not part of the Net Cost of Operations** | $ | (12,636) |
| **Total resources used to finance the Net Cost of Operations** | $ | (24,988) |
| | | |
| **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 annual leave liability | $ | 41 |
| Increase in exchange revenue receivable from the Public | | (24) |
| Other | | 11,220 |
| **Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods** | $ | 11,237 |

**Note 11. Reconciliation of Net Cost of Operations to Budget (Continued) – Unaudited**

| | | 2018 |
|---|---|---|
| **Components not Requiring or Generating Resources in Future Period** | | |
| Depreciation and amortization | $ | 222 |
| Revaluation of assets or liabilities | | 24,868 |
| Other | | (9) |
| **Total Components of Net Cost of Operations that will not Require or Generate Resources** | $ | 25,081 |
| **Total Components of Net Cost of Operations that will not Require or Generate Resources in the current period** | $ | 36,318 |
| **Net Cost of Operations** | **$** | **11,330** |

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.

**Primary business events comprised in the lines titled, "Other":**

Components Requiring or Generating Resources in Future Period, Other is primarily comprised of Future Funded Expenses, related to environmental liabilities; and changes in actuarial liability estimates. Per OMB guidance, the Department of Labor sends each reporting entity preparing financial statements actuarial liability estimates for future worker's compensation benefits amounts. These amounts include both current year and prior year. Under the CFO Act each reporting entity should include their portion of the actuarial liability for Workers' Compensation Benefits as liability on the Audited Financial Statements.

# 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 National Defense Stockpile Transaction Fund Financial Statements and Related Notes for FY 2018 (Project No. D2018-D000FE-0094.000, Report No. DODIG-2019-026)

We contracted with the independent public accounting firm of Ernst & Young, LLC, (EY) to audit the Defense Logistics Agency (DLA) National Defense Stockpile Transaction Fund (Transaction 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 Transaction 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 Transaction Fund FY 2018 Financial Statements and related notes.

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[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 six material weaknesses related to the DLA's internal controls over financial reporting. Specifically, EY found material weaknesses including: Inventory, Fund Balance with Treasury, 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 Transaction 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
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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 National Defense Stockpile Transaction Fund of the Defense Logistics Agency ("DLA"), which comprise the balance sheet as of September 30, 2018, and the related statements of net costs, changes in net position, and 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, 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 National Defense Stockpile Transaction 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 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.

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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.

**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 is comprised of strategic and critical materials that can be used in times of national emergencies. The materials include ores, metals, alloys, chemicals, high-performance fibers, energetics, etc. We found that policies, procedures, and controls surrounding documentation of procurements and disbursements, 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. 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 DFAS, has implemented the Department 97 Report Reconciliation Tool (DRRT) process as a mechanism to reconcile DLA's general ledger to Treasury. However, this tool has 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.

III. 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 beginning 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.

IV. 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.

V. 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.

VI. Information Systems – Our assessment of DLA's 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.

**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 B.

**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.

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November 14, 2018

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**Appendix A – Material Weaknesses**

**I. Inventory**

DLA's inventory is comprised of strategic and critical materials that can be used in times of national emergencies. The materials include ores, metals, alloys, chemicals, high-performance fibers, energetics, etc. Control over the inventory process is complex because of the number of locations in which inventory is stored, and the volume of different items held. 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 has not appropriately designed controls related to physical counts for the validation of existence and completeness of inventory due to the following:

- DLA has not performed physical counts of its stockpile inventory since the materials were acquired, which could date back many decades. The policies and procedures to count and verify the individual lots is not adequate to substantiate the existence and completeness of inventory. Inventory is maintained in bulk piles or in containers (drums, pallets, etc.) and grouped in lots. The material is valued based on weight. DLA performs physical counts through visual inspections of materials. Materials are not moved or weighed to complete the count and inspection. In some instances, only the perimeter of the lot can be counted and inspected, with the results being extrapolated over the entire lot.

DLA does not have controls in place to ensure the inventory balances at period end are complete and accurate due to the following:

- Policies or procedures are not in place to ensure that adjustments to record a permanent decline (impairment) in the material is recorded in the correct period. DLA's policy is to determine whether an impairment exists on a quarterly basis. The assessment is made after the close of the reporting. As a result, an impairment that existed at period-end is not appropriately reflected in the correct period.
- Policies or procedures are not in place to ensure all transactions are appropriately and accurately recorded in the period that the transaction occurred. DLA does not accrue for inventory receipts that have not been processed in DLA's general ledger system, Enterprise Business System (EBS).

DLA does not have adequate policies, procedures, and controls to ensure that inventory is properly valued in accordance with Federal Accounting Standards Advisory Board (FASAB) Statement of

Federal Financial Accounting Standards (SFFAS) No. 3, *Accounting for Inventory and Related Property*:

- Policies or procedures are not in place that describe the valuation process. The policies and procedures do not describe the criteria used to determine whether a decline in value is temporary or permanent.
- The controls are not designed to ensure that the application of the valuation methodology is consistent and in accordance with SFFAS No. 3. The design of the review controls is not sufficiently precise such that the review activity is defined, including outlining the criteria used in the performance of the review, defining anomalies that should be investigated, etc. Inventory is valued based on historical cost or market, unless the carrying amount of the material has suffered a permanent decline in value to an amount less than the cost. On a quarterly basis, an assessment is made to determine whether there are permanent declines in value.
- Policies or procedures are not in place to perform a periodic review and document the basis for determining that the benchmarks and inputs used for determining if a decline in value has occurred are appropriate.

DLA does not have policies and procedures in place to ensure that transactions are recorded consistently with the Treasury Financial Manual'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:

- The posting logic for transactions to issue material does not comply with the guidance outlined in the Treasury Financial Manual (TFM). DLA issues material on a periodic basis and the transaction is recorded in EBS accordingly. Adjustments to inventory balances (e.g. inventory receipts, issues, gains, losses, etc.) trigger a movement type through an existing interface. The movement types are configured to update the inventory ledger in EBS and the Inventory general ledger account. The business events recorded in EBS are not properly linked to the correct posting logic as established by the TFM.

***Recommendations***

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

- DLA's inventory process should include 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.

- DLA's inventory process should include policies, procedures, and controls to periodically verify the existence, completeness, and valuation of the stockpile material and any inventory movements (additions, sales, and transfers). These procedures may include:
  - Selecting a statistical sample of stockpile materials to verify the existence and completeness (weight) of each sample to establish beginning balances and selecting a limited sample on a periodic basis (i.e. annual basis) to verify the weight of each sample.
  - Preparing a rollforward schedule to show the beginning balance, additions, sales, transfers, and ending balance of stockpile materials in the current fiscal year.
- DLA should update policies and procedures related to valuing inventory to include:
  - A defined process to determine when a decline in value should be considered temporary or permanent.
  - A defined process to determine how the review of the market value of specific commodities should be selected and performed.
  - A defined process to review benchmarks used to determine market value.
- DLA's EBS posting logic and evidential matter to support the posting logic should include the following:
  - Updates to transactions noted above to ensure compliance with TFM.
  - A system-generated mapping report which ties EBS configured posting logic to EBS transaction codes and movement types and TFM transaction numbers.
  - Clear descriptions of business events and varying circumstances that impact or change the posting logic.
  - Design and implement formal policies and procedures that outline the procedures required to review for compliance with the TFM, including adequately documenting and supporting through evidential matter that adequate review procedures were performed.

**II. 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 support the FBwT balances recorded in EBS:

- DLA was unable to provide adequate supporting documentation for the beginning balance probe sample.

DLA is unable to reconcile FBwT in EBS to Treasury at the transaction level:

- DLA, in conjunction with Defense Finance and Accounting Services (DFAS), has implemented the Department 97 Report Reconciliation Tool (DRRT) process as a mechanism to attempt to reconcile EBS transaction detail to the U.S Treasury. However, the DRRT process is not sufficient to produce a complete and accurate reconciliation of DLA's general ledger to U.S. Treasury.

  - Neither DLA nor DFAS are able to provide supporting documentation for undistributed collections and disbursements identified through the DRRT process.
  - Proper controls do not exist to match accounts receivable and accounts payable balances to undistributed funds identified in the DRRT Report in a timely manner.

- 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, with many that are aged over 3 years.
- DLA, in conjunction with DFAS, failed to perform a reconciliation between DLA systems and Treasury systems.

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 $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 does not have a policy or procedure in place to document controls at DLA related to the DRRT process, or to document the end-to-end process for FBwT. DLA has not developed and finalized a DLA 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.

***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 Control Report for the Department 97 Report Reconciliation Tool (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 Cash Management Reconciliation (CMR) and DRRT process on a frequent basis.

- Evaluate current policies and procedures for documentation retention standards and update, as necessary, to ensure sufficient, appropriate supporting documentation is available to support transactions.
- 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 controls from the FBwT Process Cycle Memorandum (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-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 and DFAS to accurately understand the processes that are performed at each in order to create a comprehensive and cohesive FBwT PCM that accurately reflects the procedures, policies, and internal controls.
- Develop a comprehensive risk assessment that encompasses the risk, policies, and procedures that are performed by DLA and DFAS as part of the Fund Balance with Treasury process, and ensure that the information recorded in the risk assessment is accurate.

- 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 the data was processed correctly.
- 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 DLA suspense account balances on DLA's 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.
- 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.

**III. 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 process to create and approve obligations, and review, record and pay invoices.

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

- DLA is unable to substantiate AP and undelivered orders:
  - Supporting documentation was not provided or provided in a timely manner to substantiate the samples tested from the following accounts:
    - Negative payables
    - Downward adjustments
    - Upward/downward adjustments, undelivered 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.
  - Upward/downward adjustments were not recorded timely and in the correct period.
- 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 have policies and procedures to record obligations and liabilities incurred accurately and in the proper period:

- DLA records obligations and liabilities incurred in an incorrect period.
- DLA's accounts payable accrual methodology for outbound Military Interdepartmental Purchase Request (MIPR) transactions is not complete and accurate. 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-based 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:

- 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 (general ledger account 1010), 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 due to the following:

- DLA does not have adequate control to ensure obligation documents were approved prior to receiving goods or services and invoices were reviewed by authorized personnel.

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- DLA does not have internal controls, policies, and procedures in place to ensure MIPR information is accurately entered into EBS. DLA is at risk of not creating the purchase order within the required timeframe based on the incorrect acceptance date in EBS.
- DLA does not have sufficient controls in place to ensure that the carrier invoices, which require manual approval, and Summary Invoice are appropriately reviewed prior to payment.
- Although DLA rejected an invoice in Invoicing, Receipt, Acceptance, and Property Transfer (iRAPT), DFAS continued to process this invoice for payment in EBS. An invoice was paid even though it was deemed improper by DLA. As a result, Federal funds were not spent in a proper 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 did not ensure that the delivered date in the obligation document agreed to the date recorded in EBS and did not record good receipts in EBS in a timely manner.
- DLA's controls for the proper approval of invoice; receiving reports; and purpose, time and amount for the following accounts were not operating effectively: Account Payable, Negative Payables, and Expense accounts.
- DLA does not have adequate controls to ensure the government purchase card expenditures are approved and recorded accurately due to 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 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 a purchase order that was open for approximately three (3) years prior to being closed.
- DLA does not have policies and procedures in place to manage stale payables/obligations:

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- A timely review and monitoring is not performed for the following account balances:
    - Negative payables – There is a significant number of aged transactions that may no longer be valid.
    - Undelivered orders (UDOs), unpaid – There is a significant volume of UDO transactions which 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(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 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 HQ 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 remove 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 their 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 require 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 process and identify key internal controls over financial reporting.
- Monitor, review, and validate whether controls are operating effectively on an on-going basis.
- Update existing internal control activities to produce evidence that the control occurred (e.g. signature) after the control is executed.
- DLA should implement limiting the A/BO to one key role, 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:
    - Processes and internal controls to ensure rejected invoices outside of EBS are blocked for payment processing, even though these invoices pass the two-way and three-way match in EBS, and develop a plan for continuous monitoring to ensure controls are working effectively.
    - Processes and internal controls to ensure liabilities are recorded in the period incurred, costs are appropriately expensed or capitalized, invoices are reviewed by personnel with proper delegation of authority, and obligations are approved, as well as recorded in a timely manner.

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- 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.
- An accounts payable accrual methodology that adequately considers the nature of the liabilities incurred, data validation to ensure the data used in determining the accrual balance is appropriate, and an analysis to determine the adequacy of the methodology.
- Processes and internal controls to ensure accurate data is captured in the system.
- Internal controls to ensure invoices are paid in a timely manner or interest penalty is paid when payments are made late.
- Processes and internal controls to ensure that:
  - Obligations are recorded accurately, to include good receipts are recorded in a timely manner and funds are de-obligated within a reasonable time
  - Obligations are approved by authorizing official prior to the award, good receipt are fully supported, and appropriate supporting documentation are retained
  - Financial data, such as delivered dates, agree between the obligation document and EBS.

- 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.

## IV. 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 doc 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 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 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 DFAS posts unsupported monthly and quarterly journal vouchers (JVs) in EBS and Defense Departmental Reporting Systems (DDRS) to ensure DLA's budgetary accounts reconcile to the proprietary accounts.
- 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 and 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 validate 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 Procedure (SOP), DFAS should provide DLA the data files needed for the reconciliation five (5) days after quarter/year-end close. However, the reconciliations are completed approximately two months subsequent to the 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 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 file 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 updates within EBS.
  - Within the quarterly reviews, prior year adjustments were used as offsetting entries to current year adjustments.
- DLA does not perform a reconciliation in a timely manner to allow for adjustments to be reviewed prior to the generation of the financial statements.

During EY's review of the third quarter (Q3) FY18 and fourth quarter (Q4) FY18 financial statements 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.
  - 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 are 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 did not perform procedures to verify the accuracy of the beginning balance in general ledger (GL) account 4201, Total Actual Resources Collected.

***Recommendations***

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

- Evaluate EBS posting logic and evidential matter to ensure system posting logic is configured in compliance with USSGL and Department of Defense (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 document type to identify the type of transactions within the EBS universe of transactions.
- Implement monitoring or review controls to ensure EBS transactions are being posted as intended.
- Analyze and investigate the known budgetary to proprietary tie point variances at a business process level to determine the root cause.
- Assess the 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 process for reviewing the budget to proprietary (B2P) tie-points, including who should be performing the review, timing of the review, and at what level the review should occur, in order to ensure variances are being researched and resolved in a timely manner.
- 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.

- As a part of the Manager's Internal Control Program (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 the agreement sufficiently documents roles, responsibilities, communications, and timelines needed to support DLA's reconciliation requirements.
- Evaluate the EBS source files being interfaced to DDRS-B to determine the procedures needed to validate that the SFIS trial balance (TB) is compliant prior to interface.
- Evaluate the policies and procedures in place over the financial reporting process, including the specific roles of DLA and 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 adjustments recorded in DDRS-B could be eliminated by making the adjustments within EBS.
- 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 disclosures 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.

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    - Design and document standard operating procedures to ensure that the beginning balance for carry forward budgetary accounts are accurately stated.
- Evaluate the supporting documentation being utilized in the review of each footnote and consider developing procedures to:
    - Assess adjustments impacting the footnote disclosures.
    - Review changes between fiscal years and determine the procedures necessary to support the change.
- 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.
- Analyze and investigate the known budgetary to proprietary tie point variances related to accounts receivable and revenue 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. 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 from occurring.

**V. 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 completely 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.

DLA does not perform sufficient oversight and monitoring of system and organization control (SOC) 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 the each applicable SOC 1 report.
- DLA has unresolved control gaps related 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 were identified as possible mitigating controls.

***<u>Recommendations</u>***

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 subjected 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 the controls to determine if they are designed to appropriately mitigate the 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.
    - Include information specifically related to the Transaction Fund in the Funds Management PCM and indicate instances in which the policies, procedures, and internal controls do not apply to the Transaction Fund.

**VI. 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 the agency 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

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**(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.

**(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***

EY recommends that DLA consider implementing 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 restrict 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.

**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.

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**Appendix B – Status of Prior Year Deficiencies**

| Area | Type of Deficiency in Fiscal Year 2017 | Current Year Status |
|---|---|---|
| Inventory | Material Weakness | Not Remediated |
| Fund Balance with Treasury | 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 |

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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 National Defense Stockpile Transaction 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 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.

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**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.

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**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 – Transaction 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

Mud Task ~ Airmen perform seal checks on their gas masks at Moody Air Force Base, Georgia, February 1, 2018, during a chemical, biological, radiological and nuclear defense class.

# Other Information (Unaudited)

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

# Management Challenges

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

August 6, 2018

MEMORANDUM FOR LTG DARRELL K. WILLIAMS, DIRECTOR, DLA

SUBJECT: Major Management and Performance Challenges Facing the Defense Logistics Agency Transaction Fund

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 TF financial statements identified material weaknesses for TF. 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 |
| Fund Balance with Treasury | 1 | | | | 1 |
| Accounts Payable | 1 | | | | 1 |
| Financial Reporting | 1 | | | | 1 |
| Oversight and Monitoring | 1 | | | | 1 |
| Information Systems | 1 | | | | 1 |
| Total Material Weaknesses | 6 | | | | 6 |

DLA does not provide assurance on Internal Controls over Reporting. Management has performed its evaluation, and no assurance is provided based on the cumulative 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.

| 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 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 | 1 | | | | | 1 |
| Financial Reporting – The eliminations issue was identified while performing period-end close procedures | 1 | | | | | 1 |
| Procure 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 records | 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 Property, Plant, 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 reconciliation 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 Cards (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 Defense Finance and Accounting Service (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 Exhibits Checks demonstrates inadequate 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 material 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 DODIA Report | 1 | | | | 1 | |
| Customers are not verifying receipt of material | 1 | | | | | 1 |
| **Total Material Weaknesses** | **5** | **1** | **-** | **-** | **3** | **3** |

| **Conformance with Federal Managers Financial Integrity Act (FMFIA § 4)** | | | | | | |
|---|---|---|---|---|---|---|
| Statement of Assurance | Federal Systems do not comply with Financial Management System requirements | | | | | |
| Non-Conformances | Beginning Balance | New | Resolved | Consolidated | Reassessed | Ending Balance |
| Security Management:<br>• System Security Plan conformance and completeness across financial systems<br>• Policies and procedures out of date or not approved<br>• Monitoring of service provider and demonstrating evidence of complementary User Entity Control completion | 1 | | | | | 1 |
| Access Controls<br>• Coverage and details within Account Management Policy – Increase stringency in areas of risk<br>• Financial system Compliance with Account Management Policy – ensure all systems are in alignment to policy<br>• Alignment of Provisioning Tools with Account Management Policy – ensure tools that support account request and approval of user roles.<br>• 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 | Federal Systems do not comply with Financial Management System requirements | | | | | |
| Non-Compliance | Beginning Balance | New | Resolved | Consolidated | Reassessed | Ending Balance |
| Segregation of Duties:<br>• 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<br>• Segregation of Duties in Software Development Life Cycle | 1 | | | | | 1 |
| Contingency Planning:<br>• 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) | | |
|---|---|---|
| | Agency | Auditor |
| 1. Federal Financial Management System Requirements | Lack of compliance noted | Lack of compliance noted |
| 2. Applicable Federal Accounting Standards | Lack of compliance noted | Lack of compliance noted |
| 3. U.S. Standard General Ledger at Transaction 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 TF. 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 |
|---|---|
| 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 |
| 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 procedure that documents what should be performed for 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 - Lack of sufficient review and monitoring of DFAS Service Organization Control (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 Agency Financial Report (AFR) process, including enhancing Management Review Controls over period-end closing procedures |
| 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 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 |
| Procure to Pay - Lack of segregation of duties in the process | DLA is revising and making updates to the current the Government Purchase Card (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, 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 Stewardship Committee, Enterprise Business Cycle Owners (EBCOs), Headquarter J/D Code Organizations, MSC Directors/Commanders and their sub-organizations. The Stewardship Committee 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 Stewardship Committee/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.

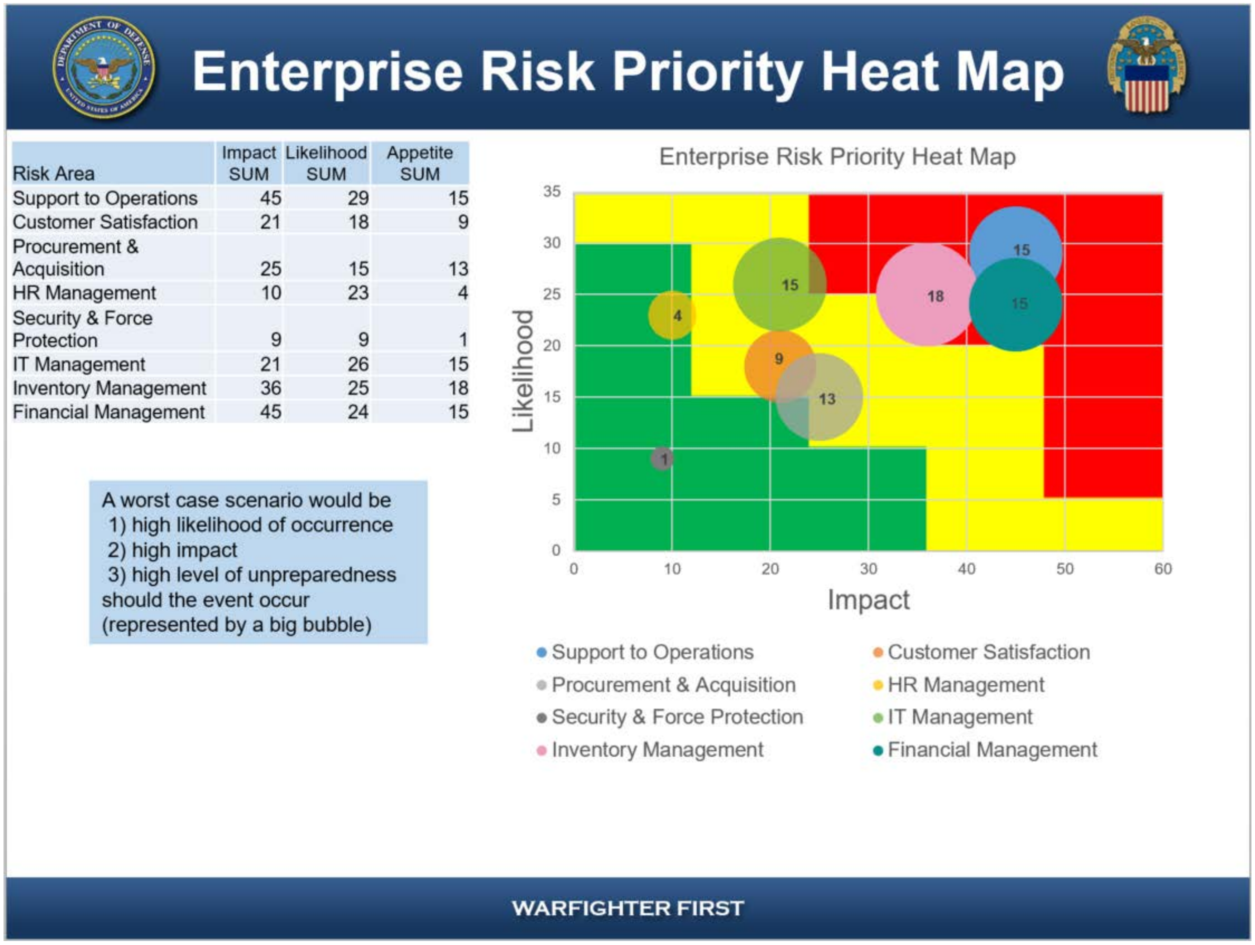


**Figure 3, Enterprise Risk Priority Heat Map**

## 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 Financial Improvement and Audit Remediation (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 Material (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 1.5% 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, 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<br>• Construction and Equipment (C&E) |
| Hire to Retire | • Employee Record Set-Up and Management<br>• Manage Payroll<br>• Manage Travel Defense Travel System Transactions<br>• Federal Employees' Compensation Act |
| Acquire to Retire | • Real Property |
| Fund Balance with Treasury and Financial Reporting and Reconciliation | • Fund Balance with Treasury<br>• 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 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 | Fund Balance with Treasury | Internal Control Test of Design and Test of Operating Effectiveness | Automated and Manual | 4 controls tested; 4 control failures |
| Financial Reporting and Reconciliation (FR&R) | Trial Balance Management | Internal Control Test of Design and Test of Operating Effectiveness | Automated and Manual | 11 controls tested; 11 control failures |
| FR&R | Invoice to Disbursement | Internal Control Test of Design and Test of Operating Effectiveness | Manual | 1 control tested; 1 control failure |
| FR&R | Billings to Collections | Internal Control Test of Design and Test of Operating Effectiveness | Automated and Manual | 4 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 Requisition | Internal Control Test of Design and Test of Operating Effectiveness | Manual | 2 controls tested; 2 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 |
| Order to Cash | Construction and Equipment | Internal Control Test of Design and Test of Operating Effectiveness | Manual | 3 controls tested; 2 control failures |

| Process Cycle | Process Cycle Memorandum Name | Test Description | Control Type | Results |
|---|---|---|---|---|
| Order to Cash | Disposition Public Sales | Internal Control Test of Design and Test of Operating Effectiveness | Manual | 5 controls tested; 4 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 |
| Hire to Retire | FECA | 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 DTS 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 TF 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 Finance 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 programs 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 (CAPS-W) systems were statistically sampled through the period ended July 31, 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 through the period ended July 31, 2018, the DLA TF recovery rate was 100%.

| Organization | FY18 Debt Value | FY17 and FY18 Total Debt Value | Debt Paid | DLA DMM Recovery Rate |
|---|---|---|---|---|
| STRAT MAT | $ 1,110 | $ 1,110 | $ 1,110 | 100% |
| **Total** | **$ 1,110** | **$ 1,110** | **$ 1,110** | **100%** |

## 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.

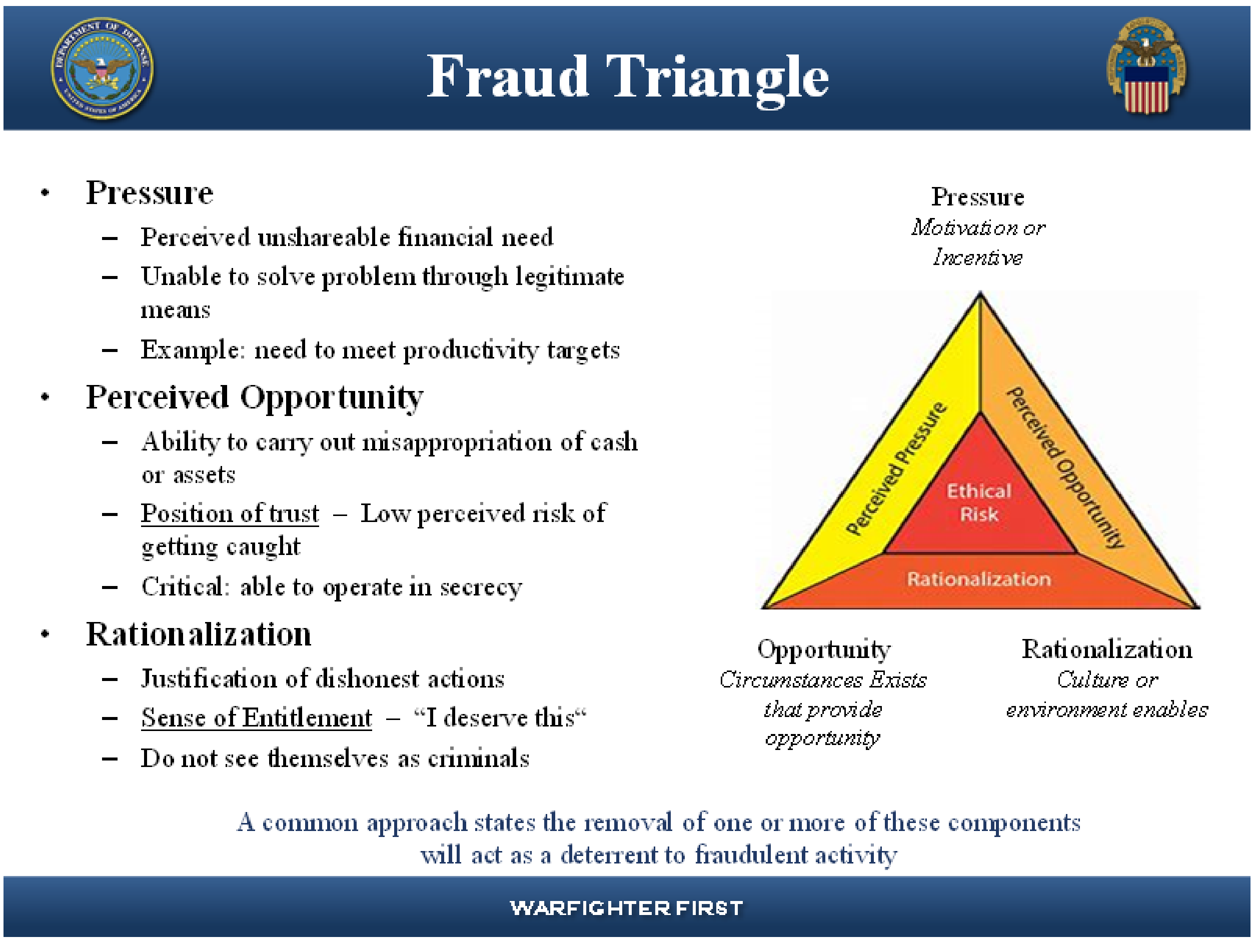


**Figure 4, Fraud Triangle**

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.

A Marine, left, uses a static discharge wand to discharge excess static electricity before attaching an M777 howitzer to a CH-53E Super Stallion helicopter during integrated slingload training at Marine Corps Base Camp Pendleton, California, April 12, 2017.

# Acronym and Abbreviation List

| Acronyms and Abbreviations | |
|---|---|
| **AA&E** | Arms, Ammunition, and Explosives |
| **A&FP** | Accounting & Finance Policy Directorate |
| **AC** | Actual Cost |
| **ADA** | Anti-Deficiency Act |
| **AFR** | Agency Financial Report |
| **AMR** | Agency Management Review |
| **APR** | Annual Performance Report |
| **CAPS-W** | Computerized Accounts Payable System |
| **CBY** | Charge Back Year |
| **CFO** | Chief Financial Officer |
| **CIO** | Chief Information Officer |
| **COLA** | Cost of Living Adjustment |
| **CMR** | Cash Management Report |
| **CPIM** | Consumer Price Index Medical |
| **CSRS** | Civil Service Retirement System |
| **CTC** | Cost to Complete |
| **DAAS** | Defense Automatic Addressing System |
| **DATA** | Digital Accountability and Transparency Act of 2014 |
| **DERP** | Defense Environmental Restoration Program |
| **DFAS** | Defense Finance and Accounting Service |
| **DLA** | Defense Logistics Agency |
| **DoD** | U.S. Department of Defense |
| **DoDAAD** | Department of Defense Activity Address Directory |
| **DoDIG** | Defense Office of the Inspector General |
| **DoDD** | DoD Directive |
| **DPCMP** | Data Profiling and Continuous Monitoring Program |
| **DTS** | Defense Travel System |
| **EBCO** | Enterprise Business Cycle Owner |
| **EBS** | Enterprise Business System |
| **EL** | Environmental Liabilities |
| **ELC** | Entity Level Controls |
| **FASAB** | Federal Accounting Standards Advisory Board |
| **FECA** | Federal Employees Compensation Act |
| **FERS** | Federal Employees Retirement System |
| **FFMIA** | Federal Financial Management Improvement Act |
| **FFMSR** | Federal Financial Management System Requirements |

| Acronyms and Abbreviations | |
|---|---|
| **FIAR** | Financial Improvement and Audit Remediation |
| **FISMA** | Federal Information Security Modernization Act |
| **FMFIA** | Federal Managers Financial Integrity Act |
| **FMR** | Financial Management Regulation |
| **FR&R** | Financial Reporting and Reconciliation |
| **FWAM** | Fraud, Waste, Abuse, and Mismanagement |
| **GAO** | Government Accountability Office |
| **GF** | General Fund |
| **HAZMAT** | Hazardous Materials |
| **ICO** | Internal Control over Operations |
| **ICOR** | Internal Control over Reporting |
| **IPERA** | Improper Payments Elimination and Recovery Act of 2010 |
| **IPERIA** | Improper Payments Elimination and Recovery Improvement Act of 2012 |
| **IPIA** | Improper Payments Information Act of 2002 |
| **IT** | Information Technology |
| **LOE** | Line of Effort |
| **LRP** | Local Risk Profiles |
| **MOCAS** | Mechanization of Contract Administration Services |
| **MSC** | Major Subordinate Command |
| **NDAA** | National Authorization Act |
| **NDS** | National Defense Stockpile |
| **NDSTF** | National Defense Stockpile Transaction Fund |
| **NFR** | Notice of Findings and Recommendations |
| **Non-BRAC** | Non Base Realignment and Closure |
| **NWRM** | Nuclear Weapon Related Material |
| **OIG** | Office of Inspector General |
| **OMB** | Office of Management and Budget |
| **OSD** | Office of the Secretary of Defense |
| **OUSD** | Office of the Under Secretary of Defense |
| **OUSD (C)** | Office of the Undersecretary of Defense, Comptroller |
| **PCM** | Process Cycle Memorandums |
| **PM** | Program Manager |
| **PPR** | Post Payment Review |
| **QA** | Quality Assessment |
| **QC** | Quality Control |
| **S&C** | Strategic and Critical |
| **RACER** | Remedial Action Cost Engineering & Requirements |
| **RCRA** | Resource Conservation and Recovery Act |

| Acronyms and Abbreviations | |
|---|---|
| **SCNP** | Statement of Changes in Net Position |
| **SES** | Senior Executive Service |
| **SFFAS** | Statements of Federal Financial Accounting Standards |
| **SM** | Strategic Materials |
| **SNC** | Statement of Net Cost |
| **SOA** | Statement of Assurance |
| **SOC** | System and Organization Controls |
| **SOP** | Standard Operating Procedures |
| **TF** | Transaction Fund |
| **TFM** | Treasury Financial Manual |
| **TI** | Treasury Index |
| **USC** | United States Code |
| **USSGL** | U.S. Standard General Ledger |
| **U.S. GAAP** | U.S. Generally Accepted Accounting Principles |
| **WCF** | Working Capital Fund |
| **WoG** | Whole of Government |

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The Nation's Logistics Combat Support Agency