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**Accounting and Information
Management Division**

B-271909 NAVY FINANCIAL MANAGEMENT:
Improved Management of Operating
Materials and Supplies Could
Yield Significant Savings

August 16, 1996

The Honorable John H. Dalton
The Secretary of the Navy

Dear Mr. Secretary:

As part of our broad-based review of various aspects of the Department of the Navy's financial management operations and its ability to meet the management and reporting requirements of the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act (GMRA) of 1994, we examined the Navy's reporting on and management of operating materials and supplies. The act specifically requires that each agency Chief Financial Officer (CFO) develop an integrated agency accounting and financial management system that complies with applicable principles and standards and provides for complete, reliable, consistent, and timely information that is responsive to the agency's financial information needs. The act also specifies that the CFO should direct, manage, and provide policy guidance and oversight of asset management systems, including inventory management and control.

In a March 1996 report,¹ we pointed out that the Navy's fiscal year 1994 consolidated financial reports did not include approximately \$14 billion of operating materials and supplies, \$5.7 billion of which are located on vessels and at 17 redistribution sites throughout the Atlantic and Pacific fleets. These operating materials and supplies include repair parts (repairables) and consumables that were purchased from the Defense Business Operations Fund (DBOF). DBOF is a revolving fund that, among other activities, finances the purchase of inventory items for the military services.²

Operating materials and supplies are separate and apart from the reported \$17.5 billion of inventory held for sale by Navy DBOF activities as of September 30, 1994.

Generally, the Navy and the Defense Logistics Agency (DLA) manage such items at two levels—the consumer level and the wholesale level (often

¹CFO Act Financial Audits: Increased Attention Must Be Given To Preparing Navy's Financial Reports (GAO/AIMD-96-7, March 27, 1996).

²DBOF consists of business areas that are managed by DOD components for providing goods and services, on a reimbursable basis, to other activities within DOD. For the Navy, the supply business area activities include the Naval Inventory Control Point and the Defense Distribution Depots managed by the Defense Logistics Agency.

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referred to as DBOF activities). The consumer level operating materials and supplies are purchased from DBOF by operating units such as Naval air stations and ships—including aircraft carriers, cruisers, frigates, destroyers, and submarines—with Operations and Maintenance (O&M) appropriations. Supply officers at these operating units are responsible for procuring items from DBOF and storing them for subsequent issue or consumption.³ At the wholesale level, inventory item managers are responsible for making Navy budget, purchase, redistribution, and other inventory management decisions. To effectively execute these responsibilities, item managers need visibility over—knowledge of and specific data on—operating materials and supplies held at the consumer level.

This report provides the results of our detailed assessment of the Navy's financial reporting on and management of operating materials and supplies that are not part of DBOF inventories. Specifically, it provides the results of our assessment of (1) the adequacy of the Navy's accountability and visibility over its approximately \$5.7 billion in operating materials and supplies on board vessels and at the redistribution sites, (2) the Navy's management of excess items of this type, and (3) the accuracy of operating unit records for operating materials and supplies that we tested. This report also contains recommendations that are directed at improving financial reporting and inventory management.

Our scope and methodology are described in appendix I. We requested comments on a draft of this report from the Secretary of Defense or his designee. On July 24, 1996, the DOD Deputy Chief Financial Officer provided us with written comments, which are discussed in the "Agency Comments and Our Evaluation" section and reprinted in appendix II.

Results in Brief

We found that the Navy's item managers did not have adequate visibility over the \$5.7 billion in operating materials and supplies on board ships and at 17 redistribution sites. Because of the lack of visibility, we had to analyze data from individual ships to identify items valued at approximately \$883 million, or about 15 percent of the \$5.7 billion, that were excess to current operating allowances or needs. The item managers' lack of adequate visibility over these operating materials and supplies,

³Federal Accounting Standards Advisory Board (FASAB) Statement no 3, Accounting for Inventory and Related Property, defines operating materials and supplies as property to be consumed in normal operations and specifies that any component that maintains or stocks operating materials and supplies for future issuance shall account for and report such items. OMB's financial reporting guidance requires agencies to disclose the amount of operating materials and supplies on hand.

particularly excess items, substantially increases the risk that millions of dollars will be spent unnecessarily as they execute their budget and spending plans for items that are already in excess at the operating unit level. For example, we determined that for the first half of fiscal year 1995, item managers had ordered or purchased items in excess at the operating level that will result in the Navy incurring unnecessary costs of approximately \$27 million. Further, a review of item managers' forecasted spending plans for the second half of fiscal year 1995 and fiscal years 1996 and 1997 found planned purchases of items considered excess at the operating level that could result in the Navy incurring approximately \$38 million of unnecessary costs.

The Atlantic and Pacific Fleets and other Navy components are pursuing their own separate nonintegrated systems projects in attempts to improve visibility and thus management of their operating materials and supplies. While these efforts represent positive steps by individual Navy components involved, they are not directed at ensuring that item managers have all the necessary data they need or CFO Act financial system and reporting requirements are satisfied. Also, these efforts are not comprehensive in that some do not capture all necessary data, such as demand data, or include all operating units needed for effective management of operating materials and supplies.

While providing item managers with visibility over excess items at the operating level can save tens of millions of dollars, the Navy could achieve further savings by eliminating redundant or unnecessary warehousing activities. These consumer-level warehousing activities are conducted at 17 redistribution sites and manage about \$455 million or half of the excess items we identified. These sites are often located in the same general areas as DBOF supply activities. Thus, these redistribution sites not only duplicate DBOF wholesale-level activities and contribute to the lack of visibility and wasteful spending by item managers, but result in the Navy incurring other unnecessary costs. For example, based on Navy information, it is incurring approximately \$2 million annually for contractor costs—including routine operating costs, such as utilities—to run 11 of the 17 redistribution sites. The other sites' operating costs and data processing support costs for all sites were not readily available.

A critical element in support of readiness and consolidated financial reporting is the accuracy of the underlying unit-level records. While all operating units should always strive to exceed the established minimum accuracy goal, we found that 22 out of the 27 sites tested met the Navy's

minimum inventory record accuracy goal of 95 percent. Those not meeting these accuracy goals can adversely affect redistribution decisions and, thus, operational readiness as well as result in poor financial management decisions.

Background

Because of its longstanding inventory management problems, DOD's inventory management is on GAO's list of high-risk federal program areas especially vulnerable to waste, fraud, and mismanagement. For the last 3 fiscal years, the Naval Audit Service reported inventory management weaknesses in its audits of DBOF activities' financial statements. In terms of Navy inventory management weaknesses, we also have reported on excess inventory at Naval aviation depots and shipyards,⁴ which are part of DBOF operations.

At the consumer level, Navy supply officers store the operating materials and supplies purchased from DBOF on ships and at shore locations, such as air stations, for subsequent issuance or consumption. In addition to items stored that are needed to meet operating requirements, these sites often have excess items stored. Also, over the past 6 years, excess items have been stored at redistribution sites as ships were decommissioned or overhauled. The fleets have been redistributing these excess items free of charge from these redistribution sites.

At the wholesale level, the Navy Supply Systems Command, through its inventory control points—the Ships Part Control Center and the Aviation Supply Office—is responsible for providing supply support to the Navy.⁵ The Ships Part Control Center is primarily responsible for the ship and submarine spare and repair parts, and Aviation Supply Office is primarily responsible for the aircraft spare and repair parts. The item managers at these inventory control points use DBOF funds to purchase items for resale. These items are stored at the Defense Distribution Depots which are part of DBOF operations and managed by the DLA. DLA also manages most common consumables. Navy and DLA item managers make decisions on (1) budgeting and buying items to support Navy operations and sales to foreign governments, (2) redistributing items among Navy units, and (3) disposing of excess items.

⁴Navy Supply: Excess Inventory Held at the Naval Aviation Depots (GAO/NSIAD-92-216, July 22, 1992) and Navy Supply: Improved Material Management Can Reduce Shipyard Costs (GAO/NSIAD-94-181, July 27, 1994).

⁵Effective October 1, 1995, the Aviation Supply Office and the Ship Parts Control Center became a consolidated Naval Inventory Control Point with two sites—Philadelphia and Mechanicsburg, Pa.

Item managers use a process called stratification to forecast requirements and determine if enough inventory will be available to satisfy them as a primary basis for budgeting. Basically, stratification reports display anticipated demand, quantities on hand, and items forecasted to be purchased during the current year and the following 2 fiscal years. These stratification reports are updated quarterly to reflect changes in purchases and requirements.

Inadequate Visibility Over Excess Items for Navy's DBOF Budget and Buy Decisions

The Navy's item managers do not have complete information on hundreds of millions of dollars of operating materials and supplies on ships and at redistribution sites that is needed for budget and purchase decisions. This occurs because the inventory systems on ships and at the redistribution sites do not provide the item managers complete and accurate data on operating level excess items. Out of the \$5.7 billion of operating materials and supplies covered in our analysis, we identified items valued at approximately \$883 million that were excess to current operating allowances or needs. Approximately \$428 million worth of these excess items, as of July 1995, were stored on board 261 Navy vessels, aircraft carriers, frigates, destroyers, and some submarines.⁶ In addition, the Navy had 17 redistribution sites storing a total of \$455 million worth of items, all of which were excess.

Operating materials and supplies are consumed during the normal operating cycles, and Navy vessels attempt to maintain sufficient stock on hand to meet their operating allowances and anticipated demand. The allowances are developed by the inventory control points based on technical and supply support information. Excesses will occur due to changes in demand and allowances for items after the fleets have purchased and stored them on ships. The Navy's downsizing also has resulted in items that had been stored on decommissioned ships becoming excess.

Excess items need to be visible for operational and budgetary purposes, otherwise readiness and spending plans can be adversely affected. Thus, to effectively manage items and reduce the risk of buying unneeded items, item managers must have complete information on what items are in excess of requirements at the Navy's operating unit level. DOD 4140.1-R, "DOD Materiel Management Regulation," requires item managers to have visibility of inventories to improve utilization and to limit buys and repairs

⁶As of July 1995, the Navy had approximately 324 vessels in the active fleet. For determining the amount of excess items on board vessels, the Navy could readily provide data on only 261 vessels, largely due to the difficulty of getting timely information from submarines.

in meeting requirements. The regulation further specifies that activities are to provide the item managers asset-level data and requirements information needed to make economical and readiness-based decisions on lateral redistribution, procurement, and repair.

To determine the effectiveness of the Navy's management of operating units' excess items, we analyzed the first half of fiscal year 1995 purchase decisions and the forecasts for the second half of fiscal year 1995 and for fiscal years 1996 and 1997 planned purchases. We used (1) the March 1995 stratification reports which supported the development of the fiscal year 1996 and 1997 forecasted requirements for the Ships Part Control Center and the Aviation Supply Office and (2) inventory data that we consolidated from 261 ships and 12 of the 17 redistribution sites.⁷

Our analysis determined that the Navy's item managers in the first half of fiscal year 1995 had ordered or purchased items in excess at the operating level that will result in the Navy incurring unnecessary costs of over \$27 million.⁸ For example, the cost to the Navy will be (1) \$2,477,320 for the purchase of four new stabilized turrets and (2) \$532,900 for the purchase of five new displacement gyroscopes. Further, the item managers' forecasted spending plans for the remainder of fiscal year 1995 and fiscal years 1996 and 1997 showed that the Navy's item managers could incur unnecessary costs of approximately \$38 million for purchases earmarked for items already in excess at the operating level. Two examples of planned purchases were (1) five cryogenic coolers with a total cost of about \$1,811,800 and (2) one main coolant pump with a price of \$2,741,590. Until item managers have full visibility over these excess items that are available to meet demand, they will not be in a position to adjust their purchase decisions to reflect such items. Thus, the fiscal year 1995 spending pattern will be repeated.

Further, the lack of visibility over excess items that are free issued has resulted in the operating unit's Operations and Maintenance budget requests being overstated. For example, many of these excess items are

⁷Only 12 of the 17 redistribution sites were included in the consolidated data base at the time we obtained the data. A complete data base, which was not readily available, would likely have resulted in additional estimated savings.

⁸In our analysis, we used the standard prices for items in order to determine the total costs to the Navy. Standard prices include a cost recovery element that is added to the acquisition cost of items. The cost recovery element includes operating costs for supply operations support, shipping and transportation, and inventory expenses, such as those for losses and obsolescence. After adjusting the standard prices for this cost recovery element, the amount ordered or purchased for the first half of fiscal year 1995 would be over \$17 million. The potential savings based on acquisition costs for the last half of fiscal year 1995 and fiscal years 1996 and 1997 would be \$24 million.

redistributed among the fleets to meet demand and without any charge to the gaining operating unit. Because these redistributed items are meeting annual operating unit demand, the fleets should fully consider the availability and use of these resources in developing their annual O&M budgets.

The Atlantic and Pacific Fleets, which account for about 40 percent of the Navy's O&M appropriation, prepare annual O&M budget requests based on projected needs for operating materials and supplies and maintenance. However, in developing their O&M budgets, they have not been adequately reducing their budgets for items received free from redistribution sites. We reported in September of 1995 that the Navy's fiscal year 1996 O&M budget could be potentially reduced by \$60 million for the items redistributed as free issue during the current period.⁹ The Navy was able to demonstrate that \$21.6 million of the \$60 million had been taken as a budget reduction, leaving \$38.4 million in potential savings.

Navy Lacks an Integrated and Comprehensive Approach to Reporting on Operating Materials and Supplies

The Navy has various initiatives underway to improve management and reporting of operating materials and supplies. These initiatives can enhance the Navy's ability to meet its CFO act consolidated financial reporting needs for operating materials and supplies and provide greater asset visibility for item managers' decision-making. However, some of these efforts are more directed at and concerned with providing visibility for redistribution of excesses among the operating activities sponsoring the initiative than providing item managers with all the data needed to perform their responsibilities from a Navy-wide perspective. Thus, unless a more integrated and coordinated approach is taken, item managers will continue to lack the necessary information needed to make the best redistribution, budget, and purchase decisions possible and the Navy's consolidated financial reporting needs will not benefit fully from these present efforts.

The CFO Act of 1990, as amended by the GMRA of 1994, requires DOD, as one of 24 agencies, to improve its financial management and reporting operations. The CFO act specifically requires that each agency's Chief Financial Officer develop an integrated agency accounting and financial management system that complies with applicable principles and standards and provides for complete, reliable, consistent, and timely information that is responsive to the agency's financial information needs.

⁹1996 DOD Budget: Potential Reductions to Operation and Maintenance Program (GAO/NSIAD-95-200BR, September 26, 1995).

The act also specifies that the CFO should direct, manage, and provide policy guidance and oversight of asset management systems, including inventory management and control. Also, new accounting standards for federal agencies and OMB's financial reporting guidance requires agencies to report on operating materials and supplies as a major line item on their financial statements. Further, OMB's guidance requires that agencies disclose specific information on these operating materials and supplies, such as their general composition, the balance for items held for use, and the amount of excess, obsolete and unserviceable items.

As previously mentioned, the Navy has an estimated \$14 billion of operating materials and supplies at air stations, Defense Distribution Depots, Trident Refit Facilities, redistribution sites, and on board all types of vessels. Of this amount, approximately 49 percent of the items are at the air stations, Defense Distribution Depots, and the Trident Refit Facilities; about 47 percent of the items are on board Navy vessels, including submarines; and about 4 percent are at redistribution sites. Numerous systems are used to account for the operating materials and supplies at these various activities. Nevertheless, most of the data on operating materials and supplies at the shore-based locations is available for financial reporting purposes and, to some limited extent, item managers have data on excess items for decision-making. However, this is not the case for those operating materials and supplies on board ships and submarines.

For example, the Atlantic Fleet has developed and implemented the Force Inventory Management Analysis Reporting System to consolidate data from ships for fleetwide visibility and redistribution among the fleet. The Pacific Fleet has tested the system and is implementing it. Yet, according to Atlantic Fleet officials, they are not planning to provide the item managers information on excesses from the system for use in their budget and buy decisions. However, the information is available for supporting consolidated financial reporting requirements, and according to Atlantic Fleet officials, they have provided such information for the Navy's fiscal year 1995 financial reports.

At the same time, the Aviation Supply Office is planning to turn over some operating materials and supplies to DBOF, such as repairables at air stations and on board about 25 ships with aircraft and helicopters—such as aircraft carriers and amphibious assault ships—which then become DBOF inventories held for sale. These DBOF inventories will remain at the operational level and accounted for by the units' own asset management

system. One aim of this change is to improve financial management and reporting, which includes improving item managers' visibility over these items. However, the Ships Part Control Center is not planning a similar change to turn over repairables to DBOF on the fleets' remaining ships and submarines.

The Aviation Supply Office's plan considered 41 Naval and Marine Corps air stations as implementation sites for this program. Twenty-four air stations will begin a phased implementation around mid-1996, and a few ships may have their first prototype system around April 1997. However, no specific implementation milestone has been set for the majority of the 25 ships and the remaining 17 air stations. According to the official responsible for the ship portion of this effort, implementation will depend on available resources, installation of upgraded automated data processing capabilities, and the fleets requesting the changes be made.

Since 1990, the Navy has developed three separate systems or programs to improve the item managers' visibility over items specifically at redistribution sites and to provide item managers demand data (on reissues and returns) which are essential for determining requirements. However, progress has been slow and the Navy has not fully achieved these objectives. For example:

- The first system was the Consolidated Residual Asset Management Screening Information System and has been in use for over 6 years. However, it has not adequately met item managers' needs because access to the system is manual and labor intensive, limiting their ability to obtain timely information, and the system does not incorporate demand data.
- The second initiative—the Residual Asset Screening Program (RASP)—enhances automated screening capabilities for identifying excess items at redistribution sites and other Navy activities, and became operational in November 1994. However, RASP only matches item managers' back orders against excess items at the redistribution sites. It does not provide item managers on-line visibility over excess items or the capability to manage current customer demand.
- The third effort—the Residual Asset Management Program—is intended to provide item managers on-line visibility over excess items and allow them to manage these assets. However, as of February 1996, it had been implemented at only 2 out of 17 sites.

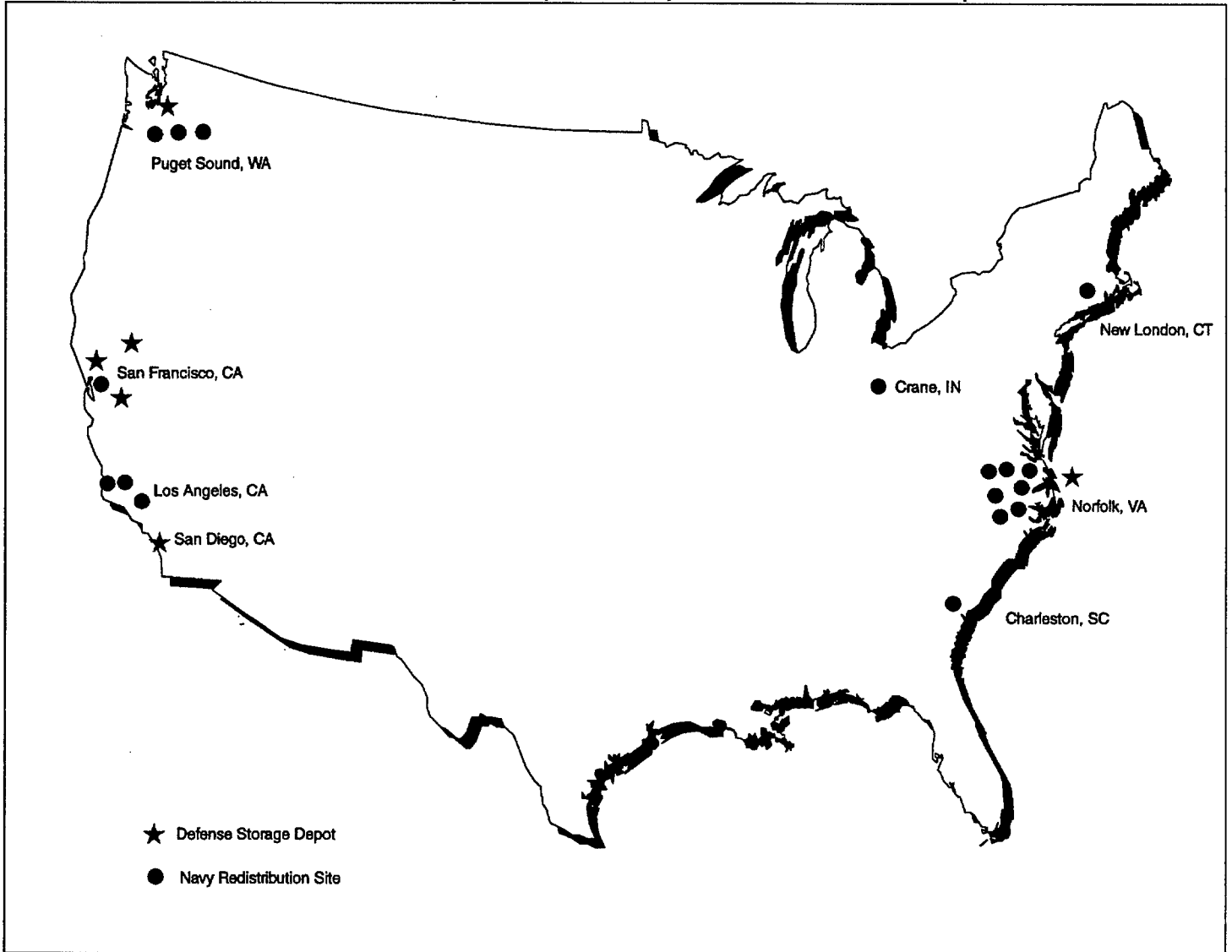
Until the Residual Asset Management Program is fully implemented, the item managers will still lack complete decision-making information on

item demand at redistribution sites. Incomplete information will be further affected by any backlog of items not entered into the system's data base. For example, three of the six sites we visited were not recording receipts of material into their inventory systems within the 30 days required by informal Chief of Naval Operations business rules, which limits the completeness of the data base and, thus, their ability to respond to demand for redistribution. At one of the six redistribution sites we visited, its reports showed 457 pallets of material had not been entered into the system, some of which had been backlogged for over 9 months.

Redistribution Warehousing Operation Is Redundant and Unnecessary

For at least 6 years, the Atlantic and Pacific Fleets, with the assistance of the Naval Sea Systems Command, have been operating redistribution sites to store excess items. During fiscal years 1994 and 1995, they had 17 major redistribution sites with approximately \$455 million of excess items (repairables and consumables) stored in them that could have been returned to the wholesale supply system. These redistribution sites are consumer-level storage facilities located in the same general geographical areas as the wholesale supply activities, such as DBOF's Defense Distribution Depots, illustrated in figure 1. The three depots at Navy's home ports—Norfolk, VA, San Diego, CA, and Puget Sound, WA—are geographically positioned to redistribute items and serve the fleets. The geographically dispersed redistribution sites are generally further away from the home ports. Thus, given the number of redistribution sites and their proximity to the home ports, the Navy could be incurring unnecessary transportation costs. In addition to contributing to the visibility problem and poorly informed budget and buy decisions by item managers as previously discussed, the Navy incurs unnecessary costs of approximately \$2 million annually to operate and manage 11 of the 17 redistribution sites. These are contractor costs that include routine operating costs such as utilities and personnel. Operating costs for the other sites and data processing support costs for all sites were not readily available. Most of these costs could be avoided if excess items were promptly returned to the wholesale supply system.

Figure 1: Locations of Defense Distribution Depots Compared to Navy's Redistribution Sites as of April 1995



Further, if these items were simply returned to the wholesale supply activities and included in their systems or sent directly to disposal if appropriate, the need for the numerous system efforts to track and report on only about 4 percent of operating materials and supplies discussed in the previous section would be eliminated. Prolonging the storage of excess items and not disposing of them can result in the Navy incurring

unnecessary storage and other costs. For example, four of the six sites we visited were holding items for more than a year. In fact, one site had been holding some items for at least 5 years.

According to DOD Directive 4100.37, "Retention and Transfer of Materiel Assets," all serviceable or economically repairable assets that are excess to retention limits should be reported to the item manager, who advises on the disposition of the assets and whether credit will be provided for returning them to the wholesale supply system. NAVSUP Publication 500, "Navy Policy and Standards for Supply Management," specifically requires that (1) repairables in excess of allowances and (2) consumables that are excess to retention limits be returned to the wholesale supply system. Further, as previously mentioned, "DOD Materiel Management Regulation," requires item managers to have visibility over assets to help maximize their redistribution. It also specifies that items returned to the supply system are to be considered in determining future requirements and that demand data, which are a factor used in determining requirements, be adjusted for these returns.

According to Navy officials, they have not promptly returned these items to the supply system because they do not routinely receive credit for them and may need them in the near future. Navy officials further explained that if they returned them promptly but found that they needed them later, they would then have to purchase them again, in essence paying twice for an item. In following up on this point, we held discussions with logistics officials at DLA and the Office of Under Secretary for Defense (Acquisition and Technology). These officials commented that financial incentives probably need to be reevaluated to help ensure that all excess items are returned to the supply system.

Under 10 U.S.C. 2208(g) and the DOD and Navy policies which implement it, activities generally will be given credit for returns when the item managers have immediate needs for the items, are purchasing the items, or have included them in the budget. However, since the fleets do not automatically receive credit and they wish to avoid paying twice for the same item, the Navy retains these items either at the operating unit or at the redistribution sites, counter to DOD's stated policy. We noted that it was the fleets' surface ship and submarine operations that were primarily storing excess ship parts and consumables at redistribution sites. According to officials who manage the Atlantic Fleet's air operations, they return excess items as required by policy and do not operate redistribution sites.

The Naval Audit Service also has been critical of the fleets' operating these redistribution sites. In a January 1992 report,¹⁰ the Naval Audit Service stated that retaining "off-line" excess inventories (1) was contrary to supply policy, (2) reduced assurance that Navy-wide priorities are met and maximum redistribution is achieved, and (3) is not efficient.

In September 1992, we reported on a similar situation with Army redistribution activities for excesses in Europe.¹¹ We recommended that the Army transfer ownership of the special redistribution inventories to the wholesale inventory managers to facilitate redistribution Army-wide. The Army concurred with our recommendation and, on October 26, 1992, directed this program to be discontinued.

Activities Generally Meeting the Navy's Minimum Record Accuracy Goal With Some Exceptions

Effectively meeting item manager and consolidated financial reporting needs is dependent on the adequacy of Navy financial systems including the accuracy of the underlying unit records. Thus, accurate unit records on operating materials and supplies are crucial to properly support readiness, ensure proper decision-making for budgets and purchases, and provide reliable financial reporting at all levels. At the 15 shore activities—air stations, redistribution sites, and Trident Refit Facilities—and 12 ships we visited to assess the accuracy of Navy's records on its operating materials and supplies, we found that 22 out of 27 met the Navy's minimum inventory record accuracy rate goal of 95 percent. We believe that to ensure reliable financial reporting and maximum operational efficiency, all units should strive to exceed the minimum goal. The accuracy rates we computed were comparable to those being reported by the activities and ships as a result of their own physical counts.

Of the 2,619 items valued at \$101.3 million in our sample, we found 100 items with quantity and location errors. The dollar value of these errors was approximately \$5.1 million. For each location, we computed accuracy rates based on the number of items with an error and the dollar value of the errors. For the locations we visited, our results showed that:

- Of eight shore activities and seven ships in the Atlantic Fleet, only two ships had item accuracy rates below 95 percent—one was 88 percent, and the other 94 percent. However, for one of these ships, the dollar accuracy

¹⁰Naval Audit Service, 011-S-92, January 15, 1992, Material Held By Type Commanders.

¹¹Army Inventory: Problems Managing Excess Supplies as the Army Draws Down in Europe. (GAO/NSIAD-92-273, September 22, 1992).

rate exceeded 95 percent. For the other ship, the dollar accuracy rate could not be determined because insufficient data were provided.

- Of six shore activities and five ships in the Pacific Fleet, one air station and one ship had item accuracy rates below 95 percent—86 percent and 88 percent, respectively. However, that ship's dollar accuracy rate exceeded 95 percent. The air station's dollar accuracy rate was only 78 percent.
- The only air station we visited under the command of the Naval Reserve had an item accuracy rate of 91 percent, and its dollar accuracy rate was 77 percent.

For the two air stations that did not meet minimum accuracy rates, errors primarily were due to the use of the wrong location identifier or we could not determine the reason. For the three ships with errors—two aircraft carriers and a frigate—our results were similar to those found in the past by the Naval Audit Service.¹² Our testing revealed that approximately half of the discrepancies were due either to unprocessed transactions or the use of the wrong location identifier; the remaining discrepancies could not be readily explained. The Naval Audit Service had found that most adjustments due to discrepancies resulted from unrecorded receipts or issues and erroneously processed transactions.

In its 1986 and 1992 reports, the Naval Audit Service recommended that the Navy develop and issue comprehensive reconciliation guidelines, improve receiving procedures on ships, enhance automation and training, and establish a focal point at the Chief of Naval Operations level to ensure that progress is made. In addition, as part of its current audit of Navy's financial reports, the Naval Audit Service is (1) testing the accuracy of unit records for operating material and supplies and (2) assessing the effectiveness of the Navy's actions in response to Naval Audit Service recommendations. We believe the Naval Audit Service's current audit of the Navy's financial reports should determine whether the Navy's actions adequately address concerns raised by our findings on unit record accuracy.

Conclusion

Item managers need to have visibility over all operating material and supplies in order to effectively support the Navy's mission and readiness goals as well as to make the most efficient use of limited resources. The present efforts to gain visibility over such items will not fully address item

¹²Naval Audit Service, S10555, September 30, 1986, Aviation Supply Management Aboard Aircraft Carriers and Naval Audit Service, 005-W-92, January 27, 1992, Followup On Aviation Supply Management Aboard Aircraft Carriers.

managers' needs and effectively meet the CFO Act financial reporting requirements. Also, the duplicative supply activities of the 17 redistribution sites are inconsistent with the central supply functions which DBOF's Defense Distribution Depots offer, and contribute significantly to the problems associated with the lack of visibility over excess operating material and supplies. By eliminating the duplication of supply activities and taking a more integrated and coordinated approach to the various asset visibility program or system efforts, the Navy is in the position to improve its ability to achieve its mission and readiness goals, substantially reduce unnecessary annual spending, and meet consolidated financial reporting requirements.

Recommendations

We recommend that the Secretary of the Navy direct the Chief of Naval Operations to take the following actions:

- Direct the fleets to eliminate redistribution sites. Until the redistribution sites are eliminated, we further recommend that the Assistant Secretary for Financial Management direct the fleets to continue reducing their O&M budget estimates by the value of the items annually issued free from these redistribution sites.
- Ensure that the various asset visibility efforts are properly coordinated and integrated to fully meet the information needs of item managers for data on operating materials and supplies.
- In conjunction with the Navy Assistant Secretary for Financial Management, ensure that the asset visibility efforts facilitate complete, reliable, and prompt consolidated financial reporting of operating materials and supplies in accordance with the FASAB Statement no. 3 and OMB's financial reporting guidance.
- Report on a quarterly basis to the Secretary of the Navy, the progress made on eliminating the unnecessary redistribution sites and the asset visibility efforts in meeting item managers and consolidated financial reporting needs.

Agency Comments and Our Evaluation

DOD generally concurred with the audit findings and most of the recommendations. However, DOD strongly disagreed with our recommendation to disestablish the redistribution sites.

DOD asserted that the redistribution centers are a sound business practice because they encourage customers to (1) move excess material to centralized sites without giving up ownership and (2) aggressively

redistribute assets internally to offset requirements. Further, DOD claimed that the use of redistribution sites limits the number of sites requiring upgraded automation and training as Total Asset Visibility initiatives progress. DOD also asserted that elimination of the redistribution sites with immediate turn-in requirements would apparently optimize the wholesale level at the expense of the consumer level and potentially drive excesses underground, resulting in reduced, rather than enhanced, inventory management at both levels. DOD suggested that an alternative to this recommendation could be to have the Chief of Naval Operations direct accelerated implementation of the Residual Asset Management program to achieve complete consideration of all assets at these sites to the Navy Inventory Control Point requirement determination programs.

While the Residual Asset Management program is intended to address our major concern (that is, item manager visibility), we believe the Navy is not pursuing this objective in the most cost-effective manner. Specifically, the Defense Distribution Depots that are colocated with the three home ports are more centralized locations than the 17 geographically dispersed redistribution sites. Since DBOF has the capacity and systems in place to give item managers appropriate visibility and oversight of excess items, the initial establishment and the continuing operation of the redistribution sites duplicates existing capabilities and is inefficient. If the Navy made redistribution decisions at the point of decommissioning and overhaul and sent items directly to the appropriate supply and repair activity at the ships' home ports to satisfy anticipated short-term future needs, then the redistribution of items might be accomplished with less transportation, handling, and storage costs. Further, disposal decisions would not be prolonged, reducing storage and other costs. With total asset visibility down to the operating unit level, redistribution sites should not be needed to encourage redistribution of Navy-owned assets and, in fact, add another operating layer requiring additional systems, people, and controls and the associated costs to properly manage them. Accordingly, we disagree with DOD that the redistribution sites represent centralized locations and limit the number of locations needing automation upgrade and training.

Without adequate financial incentives to ensure that excess items are returned to DBOF, we understand the potential for "underground" excesses and recognize this as a legitimate management concern. However, an effective and efficient supply system requires adequate financial incentives and properly designed controls. It is management's responsibility to establish proper discipline and incentives to ensure that policies and procedures are followed. As we and the Naval Audit Service have pointed

out, operating these redistribution sites is contrary to supply policies. DOD's position is also inconsistent with that taken for Army's redistribution center in Europe, as discussed in this report. It is our intent that the Navy optimize operating material and supplies management from a total Navy-wide perspective, not at the expense of the consumer level over the wholesale level. Effective Navy-wide management and oversight of operating materials and supplies should help preclude "underground" excesses.

We are sending copies of this report to the Chairmen and the Ranking Minority Members of the Senate and House Committees on Appropriations, and their Subcommittees on Defense; the Senate Committee on Armed Services and its Subcommittee on Readiness; the Senate Committee on Governmental Affairs; the House Committee on Government Reform and Oversight as well as its Subcommittee on Government Management, Information, and Technology; and the House Committee on National Security. We are also sending copies to the Secretary of Defense, Director of the Defense Finance and Accounting Service, and Director of the Office of Management and Budget. We will make copies available to others upon request.

The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on our recommendations. You must send your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight within 60 days of the date of this report. You must also send a written statement to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this report.

If you have questions regarding this report, please call me at (202) 512-9542, or Linda Garrison, Assistant Director, Defense Financial Audits, at (404) 679-1902. Major contributors to this report are listed in appendix III.

Sincerely yours,



Lisa G. Jacobson
Director, Defense Financial Audits

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Abbreviations

GMRA	Government Management Reform Act
CFO	Chief Financial Officer
DBOF	Defense Business Operations Fund
DOD	Department of Defense
FASAB	Federal Accounting Standards Advisory Board
DLA	Defense Logistics Agency
O&M	Operations & Maintenance

Scope and Methodology

To assess the adequacy of the Navy's accountability and visibility over its operating materials and supplies, we identified the inventory management systems used throughout the fleets, at depots, and at the inventory control points. We interviewed Navy personnel at the Ship Parts Control Center, the Aviation Supply Office, Navy Supply Command Headquarters, and the Atlantic and Pacific Fleets to help determine what operating material and supplies the item managers have visibility over, or needed visibility over, for decision-making. Our discussions with these Navy personnel included the status of the Navy's principle efforts to improve asset visibility, particularly over operating materials and supplies throughout the Navy. We also reviewed DOD and Navy accounting and supply policies, accounting standards recommended by the Federal Accounting Standards Advisory Board, and OMB guidance on financial reporting.

To evaluate the Navy's management of excess operating materials and supplies, we focused our work on operating material and supplies on ships and at redistribution facilities. The data we used was as of July 1995, the most current data files available at the time of our work, which covered 261 out of 324 active vessels—aircraft carriers, frigates, cruisers, destroyers, other ships, and some submarines. We compared the on-hand quantities to the ships' allowance for each item to identify potential excesses. Using the March 1995 item managers' stratification data (from the final stratification reports used in the development of fiscal year 1996 and 1997 forecasted requirements), we determined the extent to which excess items we had identified could have altered the mix of items that DBOF item managers were either purchasing or planning to purchase during fiscal years 1995 through 1997. For determining the potential dollar savings, we used the Navy's standard pricing catalog.

We used a similar methodology for evaluating other excess items using consolidated data from 12 of 17 redistribution sites as of January 1996. In addition, at 6 of the 17 redistribution sites, we examined internal controls over receipt processing, compliance with "business rules" established by the Chief of Naval Operations, costs of operations, and accuracy of unit records. We also discussed the operation of these redistribution warehouses with Navy, DLA, and Office of the Secretary of Defense supply officials.

To assess the accuracy of operating material and supplies records at the unit level, we performed physical counts at 15 shore locations and on 12 ships. These locations accounted for about 26 percent, or \$3.7 billion out of the estimated \$14 billion of operating materials and supplies. These

sites visited represented air stations, Trident Refit Facilities, redistribution warehouses, and Navy vessels—aircraft carriers, cruisers, frigates, destroyers, and other ships.

From a list of 51 naval air stations provided by the Aviation Supply Office, we selected all Naval air stations with reported operating material and supplies valued at \$200 million or greater, a total of 4 air stations. For the remaining air stations we randomly selected from those that had reported operating materials and supplies. The air stations selected had about \$1.7 billion, or 57 percent, of the approximate \$3 billion in operating material and supplies reported by the 51 Naval air stations. We selected both Trident Refit Facilities which reported \$1.5 billion of operating materials and supplies. Also, based on the highest dollar value of items stored, we selected three redistribution sites of the Atlantic Fleet and three of the Pacific Fleet. These sites constituted 61 percent of the total reported value of items held by redistribution sites—about \$455 million as of April 1995. We selected aircraft carriers, cruisers, frigates, destroyers, and other ships to visit based on their availability at home ports.

To perform our counts, we selected a random sample of 45 items from operating material and supplies records at each location for record-to-floor counts and selected an additional 45 items in the storage areas for floor-to-record counts. For each error identified, we worked with Navy supply personnel to determine the cause for it and attempted to reconcile the variance. From our results, we computed accuracy rates for each location based on quantity and location errors and the dollar value of those errors using the unit prices from the activity's or ship's records. We compared our rates with the Navy's accuracy rate goal of 95 percent and the accuracy rates determined from the units' own physical inventory programs. In addition, we reviewed Navy supply policies and procedures and results of supply management assessments at the activities we visited.

We did not assess the reliability of the automated systems from which we obtained data for our analyses.

We performed our work from January 1995 through March 1996 in accordance with generally accepted government auditing standards.

We performed work at the following locations:

Naval Supply Systems Command, Arlington, VA
Ship Parts Control Center, Mechanicsburg, PA

Appendix I
Scope and Methodology

Aviation Supply Office, Philadelphia, PA
Commander-in-Chief U.S. Atlantic Fleet, Norfolk, VA
Commander-in-Chief U.S. Pacific Fleet, Pearl Harbor, HI
Commander Naval Surface Force, U.S. Atlantic Fleet, Norfolk, VA
Commander Naval Surface Force, U.S. Pacific Fleet, San Diego, CA
Commander Naval Air Force, U.S. Atlantic Fleet, Norfolk, VA
Commander Naval Air Force, U.S. Pacific Fleet, San Diego, CA
Commander Naval Submarine Force, U.S. Atlantic Fleet, Norfolk, VA
Commander Naval Submarine Force, U.S. Pacific Fleet, Pearl Harbor, HI
Naval Station Mayport, Mayport, FL
Naval Air Station, Cecil Field, Jacksonville, FL
Naval Air Station, Whidbey Island, Oak Harbour, WA
Naval Air Station - Oceana, Virginia Beach, VA
Naval Air Station, Norfolk, Norfolk, VA
Naval Air Station, North Island, San Diego, CA
Naval Air Station, Dallas, Dallas, TX
Trident Refit Facility Bangor, Bangor, WA
Trident Refit Facility Kings Bay, Kings Bay, GA
Defense Distribution Depot, Norfolk, VA
Defense Distribution Depot, San Diego, CA
Fleet Industrial Supply Center, Norfolk, VA
Fleet Industrial Supply Center, San Diego, CA
East Redistributable Material Management System, Portsmouth, VA
West Redistributable Material Management System, Bell, CA
East Ready Resource Materials Program, Chesapeake, VA
West Ready Resource Materials Program, Auburn, WA
Shipbuilding and Conversion, Navy Consolidated Residual Asset
Management Program, St. Juliens Creek, VA
Submarine Program for Excess Redistribution, Auburn, WA
USS George Washington
USS Kitty Hawk
USS Trenton
USS Barry
USS Guam
USS Gettysburg
USS Boone
USS Shiloh
USS Tarawa
USS Ft. Fisher
USS Callaghan
USS Supply

Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100



Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
U.S. General Accounting Office
Washington, DC 20548

JUL 24 1996

Dear Mr. Dodaro:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "NAVY FINANCIAL MANAGEMENT: Millions Can Be Saved Annually by Improving Visibility and Management of Operating Materials and Supplies, dated June 10, 1996 (GAO Code 918843/OSD Case 1168)."

The Department generally concurs with the subject draft report. However, the Department does not agree with the recommendation to disestablish the redistribution sites. The Department would, however, concur with the GAO, if the recommendation were redirected to recommend that the Chief of Naval Operations:

"Direct the accelerated implementation of the Residual Asset Management (RAM) program, which provides complete consideration of all assets at residual sites, to the Navy Inventory Control Point requirements determination programs."

The detailed comments concerning the GAO recommendations are provided at the enclosure. The Department appreciates the opportunity to comment on the draft report.

Sincerely,

Alvin Tucker
Deputy Chief Financial Officer

Enclosure

See comment 1.

**DOD COMMENTS ON
GAO DRAFT AUDIT REPORT - DATED JUNE 10, 1996
OSD CASE 1168, GAO CODE 918843**

**"NAVY FINANCIAL MANAGEMENT: MILLIONS CAN BE SAVED ANNUALLY BY
IMPROVING VISIBILITY AND MANAGEMENT OF OPERATING MATERIALS AND
SUPPLIES"**

RECOMMENDATIONS

RECOMMENDATION 1: The General Accounting Office (GAO) recommended that the Chief of Naval Operations direct the fleets to eliminate redistribution sites. (p.24/GAO Draft Report)

DOD COMMENTS: Nonconcur. The redistribution centers provide a critical interface between the consumer and the wholesale levels. They provide an accessible and controllable collection/distribution point for customer owned assets. Customers are given twelve months, once the materials are at the redistribution center, to redistribute the assets before mandatory turn-in to the wholesale system occurs. The Department believes that Redistribution Centers represent a sound business practice that:

- Encourages the customer to move "excess" material to centralized sites without giving up ownership (accessibility).
- Encourages the customer to aggressively redistribute assets internally to offset requirements (prudent resource management by asset owners).
- Limits the number of sites requiring upgraded automation and training as Total Asset Visibility (TAV) initiatives progress (reduced implementation time).
- Provides focus on inventory controls (necessary for low risk wholesale utilization).
- Avoids costs associated with immediate turn-in to wholesale level or disposal (increased O&M,N budget requirements).

Redistribution sites acknowledge and optimize the partnership and needs of both the customer and the wholesale system. Closure of redistribution sites will cost, rather than save money; extend the time required to achieve TAV; increase redistribution time when the assets are

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OSD Case 1168
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Now on p. 15.

See comments 1 and 2.

Appendix II
Comments From the Department of Defense

needed; and introduce availability problems for the wholesale item manager. Elimination of the redistribution sites with immediate turn-in requirement will "apparently" optimize the wholesale level at the expense of the consumer level and potentially drive excesses underground resulting in reduced, rather than enhanced, inventory management at both levels.

RECOMMENDATION 2: The GAO recommended that the Navy Assistant Secretary for Financial Management and Comptroller direct the fleets, until the redistribution sites are eliminated, continue reducing their Operations and Maintenance budget estimates by the value of the items annually issued free from these redistribution sites. (p. 24/GAO Draft Report)

DOD COMMENTS: Concur. The Department agrees to continue reducing the Department of the Navy O&M,N budget estimates by the value of the items annually issued free from these redistribution sites. The Fleet O&M,N budgets currently exclude free issue transactions from its requirements base. The exclusion of free issue is integrated into the budget preparation process and will be continued.

RECOMMENDATION 3: The GAO recommended that the Chief of Naval Operations ensure that the various asset visibility efforts are properly coordinated and integrated to fully meet the information needs of item managers for data on operating materials and supplies. (p. 24/GAO Draft Report)

DOD COMMENTS: Concur. The Department will continue to ensure that the various asset visibility efforts properly are coordinated and integrated to fully meet the information needs of both the item managers and the customers

RECOMMENDATION 4: The GAO recommended that the Chief of Naval Operations, in conjunction with the Navy Assistant Secretary for Financial Management and Comptroller, ensure that the asset visibility efforts facilitate complete, reliable, and prompt consolidated financial reporting of operating materials and supplies in accordance with the Federal Accounting Standards Advisory Board Statement Number 3, Accounting for Inventory and Related Property, and the Office of Management and Budget's financial reporting guidance. (p. 24/GAO Draft Report)

DOD COMMENTS: Concur. Efforts will be taken to ensure compliance with the requirements of FASAB Statement No. 3 as stated in the recommendation.

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Now on p. 15.

Now on p. 15.

Appendix II
Comments From the Department of Defense

RECOMMENDATION 5: The GAO recommended that the Chief of Naval Operations report on a quarterly basis to the Secretary of the Navy, the progress made on eliminating the unnecessary redistribution sites and the asset visibility efforts in meeting item managers and consolidating financial reporting needs. (p. 24/GAO Draft Report)

DOD COMMENTS: Partially concur. As discussed in recommendation 1, the Department does not agree with the closure of redistribution sites. However, the Department does agree with quarterly reporting on asset visibility efforts.

Now on p. 15.

See comment 1.

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The following are GAO's comments on the Department of Defense letter dated July 24, 1996.

GAO Comments

1. Discussed in "Agency Comments and Our Evaluation" section.
2. We question DOD's assertions that (1) the redistribution sites are a controllable collection and distribution point, and (2) mandatory turn-in of items to the wholesale system actually occurs after 12 months. During our review, we assessed some of the controls at six of the redistribution sites that held over 61 percent of the \$455 million, as of April 1995, in excess items held at the 17 redistribution sites. We found that some of the sites were not following operating rules established by the Chief of Naval Operations. As pointed out in the report, 3 of the 6 sites were not recording receipts of materiel into their inventory systems within the required 30 days. In addition, officials at 2 sites told us that they offer items for return only if they have not had demand for a year. Further, we found that 4 of the 6 sites we visited were holding items for more than a year—1 site had been holding some items for at least 5 years. A full discussion of our control testing at the redistribution sites was not included because it is our opinion that these sites should not exist.

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