



United States General Accounting Office
Washington, DC 20548

Accounting and Information
Management Division

B-286184

September 13, 2000

Mr. Nelson Toye
Deputy Chief Financial Officer
Office of the Under Secretary of Defense (Comptroller)

Subject: Financial Management: Financial Reporting Issues Related to the Navy's Direct Vendor Delivery Initiative

Dear Mr. Toye:

As a part of our ongoing efforts to work with the Department of the Navy to prepare auditable financial statements, we have participated in several of the Navy's "clean financial statement" working groups. The Office of the Assistant Secretary of the Navy (Financial Management and Comptroller) established these working groups to address problems in financial management and reporting.

During our participation in the Inventory Held for Sale working group, the concept of Direct Vendor Delivery (DVD)¹ was discussed as a way to improve supply chain management and its impact on financial reporting. Representatives from the Navy Supply Systems Command (NAVSUP) had questions regarding how a DVD contract would affect the Navy's financial reporting. NAVSUP requested input from the audit community regarding DVD requirements. Specifically, they asked the following questions.

- Would accounting and auditing standards require DVD contractors to report individual transactions through the Transaction Item Reporting (TIR)² system?
- What level of reporting would be required under a DVD contract to meet accounting and auditing standards?

We presented the attached briefing to the working group to address these questions. We are sending this information to you because it has come to our attention that other DOD components currently use DVD or are considering similar initiatives. For example, similar programs include (1) the Defense Logistic Agency's Medical and Food Prime Vendor

¹The DVD initiative involves awarding contracts to commercial vendors to provide inventory directly to Navy customers in time to meet their needs, thus reducing use of Navy resources.

²The Navy TIR system provides daily, electronic processing of inventory transactions which allows inventory managers on-line visibility of inventory on hand.

initiatives, which are aimed at reducing agency inventory levels and related costs while improving customer service and (2) the Air Force's Virtual Prime Vendor initiative, which uses a single contractor to supply parts to repair shops and depot maintenance facilities for its aircraft.

In response to the first question, accounting standards or audit requirements would not necessitate TIR reporting. The needs of inventory managers and DOD's Total Asset Visibility requirements should be the primary consideration when considering the timeliness and method of updating inventory records.

As for the level of detail necessary to meet audit requirements, the briefing outlines the information necessary to provide a sufficient audit trail for DOD management and external auditors. More specifically, if periodic reporting under a DVD contract is timely, accurate, and creates an audit trail back to a source document, it would be acceptable for audit purposes. We outlined in the briefing how those criteria could be met. Additionally, the briefing presents other opportunities that the DVD concept may provide to address financial management and reporting issues.

Representatives from the DOD Office of the Inspector General, Naval Audit Service, Office of the Assistant Secretary of the Navy (Financial Management and Comptroller), and Navy Supply Systems Command attended the working group briefing. The officials thanked us and indicated that the briefing had been very helpful. They generally agreed that the briefing accurately presented the issues and the options for addressing the questions that had been raised regarding how DVD contracts would affect the Navy's financial reporting.

This briefing was presented to support the Navy's efforts to improve its supply chain management. We hope that other DOD components will also find these comments and suggestions regarding DVD contract structure to be useful. Thank you for your consideration of these comments and for the opportunity to contribute to DOD efforts to improve supply chain management and financial reporting.

We are also providing copies of this briefing to James R. Speer, Principal Deputy Assistant Secretary of the Air Force, Financial Management; Ernest J. Gregory, Deputy Assistant Secretary of the Army (Financial Operations); and Anthony A. Tisone, Director, Office of Financial Operations, Assistant Secretary of the Navy (Financial Management and Comptroller). Copies will be made available to others on request. If you have further questions regarding the contents of the briefing, please contact me at (202) 512-9095. Key contributors to this assignment were William Cordrey, Rod Hogan, and Lisa Warde.

Sincerely yours,



Lisa G. Jacobson
Director, Defense Audits

Enclosure

March 21, 2000, Briefing

GAO Reporting Requirements for DVD

**Briefing to Navy Supply Systems
Command**

March 21, 2000

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GAO Background

- Congress required DOD to adopt best commercial practices to improve inventory management.
- As a part of this, Navy designated Direct Vendor Deliver (DVD) as one initiative to improve supply chain management.
 - DVD initiative would involve awarding contracts to commercial vendors to manage Navy owned inventory and ship directly to Navy customers in time to meet their needs (and thereby reduce Navy's handling costs).

GAO Background (Cont.)

- During meetings with the Inventory Logistics Working Group, NAVSUP requested input from the audit community regarding DVD requirements.
 - What level of reporting would be required under a DVD contract to meet accounting and auditing standards?
 - Would accounting and auditing standards require DVD contractors to report individual transactions (through Transaction Item Reporting-TIR)?

GAO Financial Management vs. Audit
Requirements

- The reporting and visibility of inventory are primarily financial management issues.
- If the periodic reporting is timely and accurate, and the data can be supported by original documents, such reporting would meet audit requirements.

GAO Required Timing of Reporting

- Required levels of reporting to meet accounting and auditing standards do not necessitate TIR reporting.
- Monthly (summary) reporting is acceptable if:
 - controls are in place to ensure timely and accurate information is provided
 - an audit trail is maintained
 - contract includes audit clauses to allow for counts and other testing procedures if selected under a financial (or other) audit

GAO Required Detail of Reporting

- Information from contractors would need to include the same key information provided under TIR, but at a summary level.
 - Report by NIIN, include number and value:
 - on-hand at beginning of period
 - inventory additions (purchases, turn-ins)
 - inventory reductions (sales, disposals)
 - adjustments (for physical counts, etc.)
 - on-hand at end of period
 - Reconcilable to other records such as billings for new purchases.

GAO Required Support of Reporting

- Monthly reports would need to be maintained by Navy and contractor for audit.
- Contractors would need to maintain support for each element in the monthly report (i.e., support for number and value of items purchased, disposed of, or sold in a month).
 - Need to be able to support federal financial reporting standards including reporting cost of sales, etc.
- Retain support in accordance with the government's record retention standards.

GAO Total Asset Visibility and DVD

- Because the items transferred or held under the DVD contract would remain Navy-owned assets, there are other considerations beyond the accounting and auditing concerns.
 - The Department of Defense has established an initiative to gain “Total Asset Visibility” (TAV) for its inventory. Since these items would remain under the ownership of Navy, they would need to meet the standards established under the DOD initiative.
- TAV requirements would need to be considered in any future DVD contracts.

GAO Possible DVD Opportunities

- Navy may be able to use DVD to improve other areas of inventory management.
- Navy DVD contracts could leverage contractor systems to improve financial accountability and reporting.

GAO Possible DVD Opportunities (cont.)

- Since vendor would completely manage the inventory for an item, its systems could maintain “historical cost” for the inventory.
 - Contractor should have an existing system that provides historical cost (sales price) information for financial reporting.
 - Contractor systems could provide inventory value at an acceptable historic cost basis.
 - The contractor could provide this historic cost information to improve Navy’s financial reporting.

GAO Reporting Exhibit A

NIIN		01-234-5678		00-123-4567		LL-123-4568	
		Balance	Value	Balance	Value	Balance	Value
Beginning	Balance	5	\$ 2,500.00	15	\$ 2,142.86	4	\$ 2,800.00
	Purchases	3	\$ 1,500.00	0	\$ -	7	\$ 4,900.00
Rec'd from	Turn ins	0	\$ -	0	\$ -	3	\$ 2,100.00
	Sales	1	\$ 500.00	5	\$ 714.29	0	\$ -
	Disposals	1	\$ 500.00	0	\$ -	0	\$ -
	Adjustments	1	\$ 500.00	-3	\$ 428.57	0	\$ -
Ending	Balance	7	\$ 3,500.00	7	\$ 1,000.00	14	\$ 9,800.00
	Note	1		2			
Notes:							
1	Physical inventory count dated 8/24/2000 showed 1 additional item						
2	Records adjusted to match 7 actually on hand						

If all items of inventory are not maintained in a serviceable condition, the number of items in each condition would need to be indicated.

GAO Reporting Exhibit B

NIN		Beginning		Rec'd from			Ending	
		Balance	Purchases	Turn-ins	Sales	Disposals	Adjustments	Balance
01-234-5678	Balance	5	3	0	1	1	1	7
	Value	\$2,500.00	\$1,500.00	\$ -	\$500.00	\$ 500.00	\$ 500.00	\$3,500.00
00-123-4567	Balance	15	0	0	5	0	-3	7
	Value	\$2,142.86	\$ -	\$ -	\$714.29	\$ -	\$ 428.57	\$1,000.00
LL-123-4568	Balance	4	7	3	0	0	0	14
	Value	\$2,800.00	\$4,900.00	\$ 2,100.00	\$ -	\$ -	\$ -	\$9,800.00
Notes:								
1 Physical inventory count dated 8/24/2000 showed 1 additional item								
2 Records adjusted to match 7 actually on hand								

If all items of inventory are not maintained in a serviceable condition, the number of items in each condition would need to be indicated.

GAO Reporting Exhibit C

NIN		Beginning		Rec'd from			Ending	
		Balance	Purchases	Turn ins	Sales	Disposals	Adjustments	Balance
01-234-5678	Value	\$2,500.00	\$1,500.00	\$ -	\$500.00	\$ 500.00	\$ 500.00	\$3,500.00
00-123-4567	Value	\$2,142.86	\$ -	\$ -	\$714.29	\$ -	\$ 428.57	\$1,000.00
LL-123-4568	Value	\$2,800.00	\$4,900.00	\$ 2,100.00	\$ -	\$ -	\$ -	\$9,800.00
01-234-5678	Balance	5	3	0	1	1	1	7
00-123-4567	Balance	15	0	0	5	0	-3	7
LL-123-456	Balance	4	7	3	0	0	0	14
Notes:								
1 Physical inventory count dated 8/24/2000 showed 1 additional item								
2 Records adjusted to match 7 actually on hand								

If all items of inventory are not maintained in a serviceable condition, the number of items in each condition would need to be indicated.