

**DOCUMENT RESUME**

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[Physical Inventory Programs of the Army and Navy Can Be Improved]. LCD-78-247; B-146828. October 24, 1978. 6 pp.

Report to Secretary, Department of Defense; by Richard W. Gutmann, Director, Logistics and Communications Div.

Issue Area: Facilities and Material Management (700).

Contact: Logistics and Communications Div.

Budget Function: National Defense: Department of Defense - Military (except procurement & contracts) (051).

Organization Concerned: Department of the Army; Department of the Navy.

Authority: DOD Instruction 4140.35.

Controls over the physical inventories of the Army and Navy were studied to determine if their objectives were being accomplished and if performance standards were being met. Department of Defense (DOD) Instruction 4140.35 prescribes the basic elements of the physical inventory control program and allows the individual services to impose more stringent requirements which they have done in their implementing instructions. However, the elements of a good physical inventory program often were not carried out. Deficiencies included: nonperformance of the required number of physical inventories, location surveys, or location audit reconciliations; inventory adjustments in excess of the number and value allowed for an acceptable level of performance; failure to process receipts and issues within the prescribed time; and inability to fill orders because stock was not at the locations shown on the inventory records. Problems identified in carrying out the physical inventory program involved: lack of experienced personnel, high employee turnover, incorrect first counts, poor control of in-float documentation, storage practices, ineffective quality control programs, and lack of reviews by internal audit organizations. (RRS)



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

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LOGISTICS AND COMMUNICATIONS  
DIVISION

B-146828

October 24, 1978

The Honorable  
The Secretary of Defense

Dear Mr. Secretary:

We have been studying the controls over the physical inventories of the Army and Navy to determine if their objectives were being accomplished and if established performance standards were being met.

Reports issued several years ago described extensive inaccuracies in inventory records. Since that time, the Department of Defense and individual military services have issued regulations and taken other actions designed to improve the controls over inventories. Nevertheless, our current study showed that established performance standards often still were not met and that further improvements are possible.

We made our study at Defense and service headquarters, Army Communications and Electronics Materiel Readiness Command, Army Troop Support and Aviation Materiel Readiness Command, New Cumberland Army Depot, Tobyhanna Army Depot, Naval Aviation Supply Office, Naval Ships Parts Control Center, Norfolk Naval Supply Center, and Norfolk Naval Air Station.

PHYSICAL INVENTORY PROGRAM

DOD Instruction 4140.35 prescribes the basic elements of the physical inventory control program. They are aimed at establishing (1) uniform practices for maintaining accurate records, conducting physical inventories, researching potential inventory discrepancies, and controlling quality of work processes, (2) comparable measures of performance for cost effectiveness analysis among the various inventory control systems, and (3) reporting procedures necessary to measure the effectiveness of physical inventory control at selected points in the Defense supply system.

In some cases the instruction gives specific goals. For example, the acceptable accuracy standard for stock locator records and inventory records is 97 percent and 85 percent, respectively.

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(943038)

The instruction allows the individual services to impose more stringent requirements and they have done so in their implementing instructions.

PERFORMANCE CAN BE IMPROVED

The elements of a good physical inventory program often were not properly carried out at the locations visited. Some deficiencies we noted during the 1975-77 time frame included

- not doing the required number of physical inventories, location surveys, or location audit reconciliations;
- making inventory adjustments in excess of the number and value allowed for an acceptable level of performance;
- not processing receipts and issues within prescribed time standards; and
- not being able to fill many orders because stock was not at the locations shown on the inventory records.

The volume of inventory adjustments illustrates the problems. Adjustments are required when the inventory records do not agree with the physical counts. There are established standards for acceptable performance that cover both the number and value of the adjustments. In the Army and Navy, the number of major adjustments (over \$500) shall not exceed 10 percent of the line items inventoried. In addition, the ratio of the dollar value of gross adjustments (gains plus losses) to the book value of the items inventoried shall not exceed 2.5 percent in the Army and 3 percent in the Navy.

At the Norfolk Naval Supply Center, the number of major adjustments ranged from 26 to 41 percent of the items inventoried during the eight quarters ended in June 1977, or well in excess of the 10-percent standard. The value of the adjustments met the 3-percent standard in one quarter but ranged from 4 to 16 percent in the other seven quarters.

At the Norfolk Naval Air Station, the number of major adjustments ranged from 12 to 24 percent of the items inventoried during the seven quarters ended in June 1977.

The value of the adjustments met the standard in one quarter but ranged from 4 to 13 percent in the other six quarters.

The situation was similar in the Army. The Electronics Command, which stores material at six depots, including the two depots in our study, had major adjustments for the six depots ranging from 22 to 42 percent of the number of items inventoried during the seven quarters ended in June 1977. The dollar value of gross adjustments ranged from 6 to 10 percent of the value of the items inventoried during the same period, or well above the 2.5-percent standard.

The Aviation Command, which stores material at four depots, including one of the depots in our study, had major adjustments for the four depots ranging from 18 to 38 percent of the number of items inventoried during the eight quarters ended in June 1977. The dollar value of gross adjustments met the 2.5-percent standard in one quarter but ranged from 5 to 11 percent in the other seven quarters.

The Army Materiel Development and Readiness Command has taken action to broaden the base for computing the ratio of inventory adjustments. For percentage of items, it is using the total number of items in the inventory as the base rather than the number of items actually inventoried. For percentage of dollar value, it is using the value of the total inventory as the base rather than the value of the items actually inventoried. The change obviously improved the accuracy rates but we noted instances where the 90- and 2.5-percent standards still were not met.

Command officials made the change because they feel that their way of selecting items to be inventoried makes those items prone to error more likely candidates to be chosen than other items. Because the base includes the number and value of more items than are actually inventoried, we believe it is not a valid method for computing inventory accuracy. It overstates the accuracy level and is inconsistent with the method used by other Defense components.

### INVENTORY PROBLEMS

We identified several problems in carrying out the physical inventory program which affect the accuracy of records and effective supply management.

The number of inventories taken and count accuracy were affected by the lack of experienced personnel (counters) to perform physical inventories and by high employee turnover. In some cases formal training of inventory personnel also was lacking.

There was a high incidence of second and third counts because first counts were incorrect; in-float documentation was not considered or controlled properly; or prior adjustments were wrong. The poor control of in-float documentation also affected the reconciliation and adjustment process.

Storage practices also hampered the physical counts. We observed that pallets were not stored in a manner which would facilitate counting, multiple open containers were in the same storage location, and mixed stock was in the same location.

Some installations did not have an effective quality control program to test and check the inventory process and to identify problem areas.

In addition, we noted that the Army or Navy internal audit organizations had not reviewed for several years the physical inventory programs at the depots visited.

## CONCLUSIONS

Accurate inventory records are essential to effective supply management which requires critical day-to-day decisions concerning what items to stock, what to buy, what to repair, and what to dispose of. Inaccurate records can cause adverse effects--if stock exists but is not on the inventory record, unneeded stock may be purchased and if stock is on the inventory record but does not physically exist, customer needs may not be satisfied.

A well-managed, sound physical inventory program is essential to provide an environment for effective and efficient supply management. Absence of a sound inventory system, poor inventory performance, and lack of aggressive management action at all levels--depots, inventory control points, commands, and headquarters--promote apathy in dealing with inventory records and problems which affect supply management effectiveness.

Our prior reports <sup>1/</sup> described extensive inaccuracies in inventory records. The current study shows that the inaccuracies and other inventory problems have continued. Because the deficiencies and their causes are repetitive of earlier reviews and are indicative of problems which continue to occur despite Defense efforts to correct them, it is difficult to devise a specific solution.

Certainly the importance of the physical inventory program and its benefits to supply management effectiveness have to be emphasized. Also, top management officials may need to be more critical when performance standards are not met and get more directly involved in correcting the inventory problems. Increased internal audit coverage also is needed. Further, Defense should not overlook the possibility of fraud and theft as causes for the large inventory discrepancies mentioned in this report.

In addition, ways to better the existing physical inventory program should be studied. The study could cover matters, such as the reasonableness of the existing performance standards, increasing the use of statistical sampling techniques, stretching out the frequency of physical inventories for certain types of material (such as slow moving, inactive, or obsolete items), limiting receipt and issue activity during the inventory process, and better controlling in-float documentation.

We discussed our observations with Defense officials and they expressed general agreement. They stated that the physical inventory procedures were being incorporated in the Military Standard Transaction Reporting and Accounting Procedures Manual. This is expected to provide better program visibility.

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1/Improved inventory controls needed for the Army, Navy, and Air Force, and Defense Supply Agency (B-146828, Nov. 14, 1967).

Army inventories--inaccuracies, effects, and ways to improve (B-146828, Feb. 26, 1971).

Air Force physical inventory problems still exist (B-146828, Sept. 28, 1971).

Your additional thoughts on the matters discussed in this letter and any actions taken in response to our observations would be appreciated. Copies of this report are being sent to the Director, Office of Management and Budget, and the Secretaries of the Army and the Navy.

Sincerely yours,

A handwritten signature in black ink, appearing to read "R. W. Gutmann". The signature is written in a cursive style with a horizontal line through the middle.

R. W. Gutmann  
Director