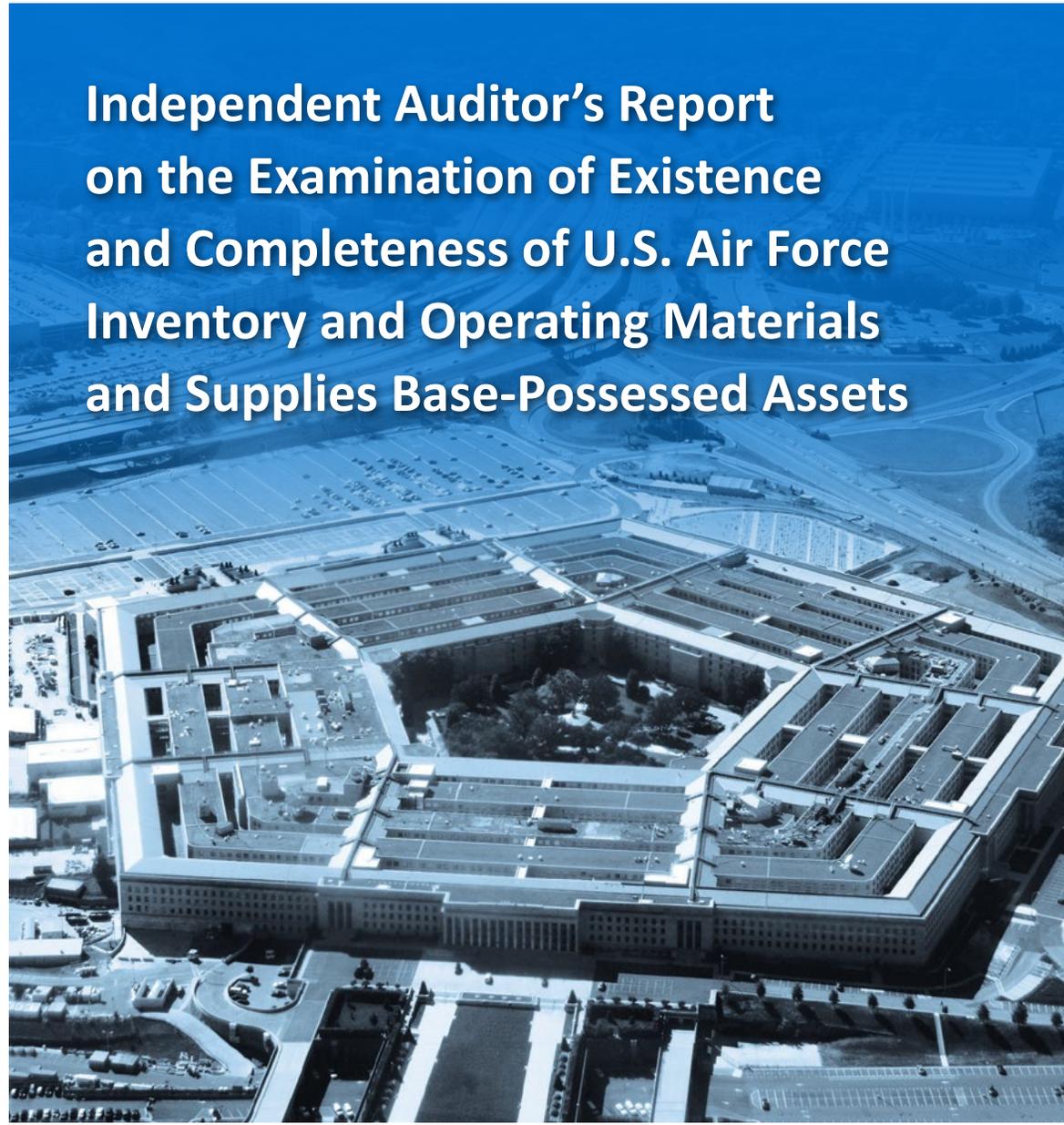




INSPECTOR GENERAL

U.S. Department of Defense

DECEMBER 4, 2017



Independent Auditor's Report on the Examination of Existence and Completeness of U.S. Air Force Inventory and Operating Materials and Supplies Base-Possessed Assets

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ALEXANDRIA, VIRGINIA 22350-1500**

December 4, 2017

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF
FINANCIAL OFFICER, DOD
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL
MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Examination of Existence and Completeness
of U.S. Air Force Inventory and Operating Materials and Supplies Base-Possessed
Assets (Report No. DODIG-2018-039, Project No D2017-D000FT-0122.000)

We are providing this report for your information and use. No written response to this report is required. Therefore, we are publishing this report in its final form. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and generally accepted government auditing standards.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945.

A handwritten signature in cursive script that reads "Lorin T. Venable".

Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting





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Audit Opinion

We examined Air Force management's assertion of audit readiness for the existence and completeness of the Air Force's base-possessed inventory and operating materials and supplies (OM&S) assets.¹ Air Force Financial Management defined "base-possessed" assets to include all applicable inventory and OM&S assets physically located in any Logistics Readiness Squadron Materiel Management warehouse, receipted in the Integrated Logistics System-Supply (ILS-S), or located in maintenance squadron sites on Logistics Readiness Squadron details. The Air Force specifically excluded from this assertion military equipment, cruise missiles, aerial targets, and drones; spare engines, uninstalled missile motors, medical equipment, real property, munitions, general equipment, government furnished equipment, depot-possessed and contractor-managed and contractor-possessed weapon system spares. Specifically, we examined the assets contained in the Air Force's accountable property system of record as of March 31, 2017. The ILS-S is the accountable property system of record for the Air Force. We did not determine whether the ILS-S universe reconciled to the general ledger because the Air Force only asserted to the accountable property system of record, which is different from the general ledger.

Air Force management is responsible for its assertion of audit readiness. Our responsibility is to express an opinion on the assertion based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and with generally accepted Government auditing standards.

¹ Audit readiness per the April 2017 "DoD Financial Improvement and Audit Readiness Guidance." Specifically, Appendix C, Wave 3 – Mission Critical Asset Existence and Completeness Audit Key Supporting Documents.

The Air Force asserted audit readiness of its base-possessed inventory and OM&S assets on June 30, 2015. The Air Force provided an updated universe of transactions (UoT), as of March 31, 2017, because Air Force personnel regularly use, expend, or ship their inventory and OM&S assets. The March 31, 2017, UoT consisted of an estimated 44 million assets (1,596,470 national stock numbers) valued at \$12.3 billion.²

We used statistical and nonstatistical methods to test the assertion. See the Appendix for details on the statistical and nonstatistical tests.

We identified two scope limitations related to the Air Force control weaknesses for producing an accurate UoT and effectively monitoring financial and management data in the ILS-S. Specifically:

- The Air Force included at least 7,807 assets, valued at \$192.7 million that were not base-possessed assets.³ Instead, these assets were either contractor-held, or located at a depot-level repair facility. The Air Force did not inform the audit team that these assets were included in the UoT; the Air Force stated that it is in the process of determining how many more non-base-possessed assets are included in the UoT.
- The Air Force did not perform an analysis to determine whether the UoT assets were appropriately classified as inventory or OM&S. Specifically, the Air Force stated that equipment, including individual protective equipment (IPE), small weapons, light arms, and other equipment were excluded from its assertion. However, the UoT included at least 463,044 IPE and hand tool assets valued at \$10.5 million. In addition, 889,927 assets valued at \$3.9 billion could also meet the accounting definition of equipment, as opposed to the logistics processes for inventory or OM&S. The Air Force had not performed sufficient analysis of the asset types included in the ILS-S, and instead relied on cataloging data to categorize the assets. Air Force personnel did not demonstrate the data was populated based on accounting standard definitions, and the Air Force did not review the data to determine compliance with the Federal generally accepted accounting principles definition of inventory or OM&S.

Because the restriction on the scope of our examination discussed in the preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on whether the Air Force base-possessed inventory and whether OM&S assets were complete and accurate in the ILS-S.

² The Air Force identified the total assertion value was \$13.4 billion as of June 2015, but the Air Force did not assert to inventory and OM&S valuation. We use the valuation amount in this report to give context to the significance of the weaknesses identified because the range of value of inventory and OM&S assets is significant.

³ Air Force specifically excluded depot-possessed and contractor-managed from their base-possessed assertion.

Internal Controls

Office of Management and Budget (OMB) Circular A-123, “Management’s Responsibility for Enterprise Risk Management Internal Control,” July 15, 2016, requires management to develop and maintain effective internal controls to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Internal controls are a process influenced by an entity’s oversight body, management, and other personnel that provides reasonable assurance that the objectives of an entity are achieved. During our examination, we identified internal control weaknesses in the Air Force management’s proper categorizing of all material contractor-held, depot-possessioned, and equipment assets. We identified other weaknesses that did not negatively affect our conclusion on Air Force’s assertion.

We identified the following seven internal control weaknesses.

- The Air Force did not have adequate controls to ensure it excluded depot-possessioned contractor-held assets in the ILS-S. Included in the UoT is a base location code for contractor-held assets valued at \$158 million, even though Air Force personnel excluded contractor-held assets as part of its assertion. Air Force personnel stated that this base location code is merely a financial reporting pass-through and they account for the assets in another system. However, the Air Force included these assets in the March 31, 2017, ILS-S UoT. Air Force personnel did not provide us with adequate assurance that there are no other depot-possessioned contractor-held DoD activity address codes included in the UoT. The Air Force should establish internal controls to ensure only base-possessioned assets are included in the base-possessioned UoT if they continue to create a base-possessioned UoT. Air Force Headquarters personnel stated they are working with the Air Force Major Commands and logistics personnel to remove these assets from the ILS-S.
- The Air Force did not have controls to ensure they excluded depot-possessioned assets in the UoT. Specifically, Air Force included assets in the UoT from at least two locations, Kadena Air Base, Okinawa, and the U.S. Coast Guard Air Station Elizabeth City, North Carolina, that included depot-possessioned assets valued at approximately \$35 million. Air Force personnel stated they were unaware that depots could order assets through the ILS-S. The Air Force was unable to determine if there are additional depot-possessioned DoD activity address codes included in the UoT. The Air Force should establish guidance and internal controls to ensure depot-possessioned assets are accounted for in the proper accountable property system of record. In response to the audit team’s discussion draft report, Air Force logistics personnel stated that they subsequently also identified that the UoT included Joint Base San Antonio – Randolph, which encompasses depot-possessioned assets. Air Force Headquarters personnel stated that they are working with the Air Force Major Commands and logistics personnel to remove these assets from the ILS-S.

- The Air Force did not have adequate controls to ensure that only inventory and OM&S were included in the UoT. Instead, the Air Force included other property, plant and equipment assets in the UoT. The Statement of Federal Financial Accounting Standards (SFFAS) No. 3 defines inventory as “tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be used in the provision of services for a fee.” SFFAS No. 3 defines OM&S as “tangible personal property to be consumed in normal operations.” SFFAS No. 6 defines Property, Plant and Equipment as tangible assets that (1) have an estimated useful life of 2 or more years, (2) are not intended for sale in the ordinary course of business, and (3) are intended to be used or available for use by the entity.” The Air Force improperly included IPE; small arms and light weapons; and other equipment in their UoT. Specifically:
 - **IPE.** Air Force Financial management concluded in a June 2, 2016 memorandum that all physical personal property, such as helmets and hand tools, meet the SFFAS No. 6 Property, Plant, and Equipment definition and should be classified accordingly. Because Air Force Financial management specifically excluded general equipment from its assertion, no physical personal property or hand tools should have been included in the UoT. However, there were 463,044 IPE and hand tool assets, valued at \$10.5 million, included in the UoT. The Air Force did not perform additional procedures in the ILS-S and its logistics readiness warehouses to determine what assets were designated IPE and should be excluded from the ILS-S.
 - **Small Arms and Light Weapons.** The March 31, 2017, UoT included 189,571 assets, valued at \$120.4 million. These assets were classified in the ILS-S as small arms and light weapons (under 30 mm); larger weapons (over 30mm); and miscellaneous weapons.⁴ Air Force personnel initially confirmed that these assets were equipment and that the Air Force stores these items in restricted access areas and not in the logistics readiness supply warehouse. However, Air Force personnel subsequently informed the audit team that the small arms and light weapons should be classified as OM&S instead of equipment because these assets are intended to be attached to a helicopter or aircraft and the Air Force cannot use the assets for other purposes. Nevertheless, the Air Force was unable to provide clear documentation that showed the proper accounting of small and large weapons that are classified as equipment versus those classified as OM&S. In addition, the Air Force did not perform testing to demonstrate that they had internal controls to prevent reporting small arms and light weapons in its UoT.

⁴ Examples of miscellaneous weapons include bracket adapter racks and pylon mission kits.

- **Other Equipment.** The March 31, 2017, UoT included 889,927 assets, valued at \$3.9 billion, which were classified as equipment by the item description. There is a risk that some of the assets classified as equipment by the item description might still meet the OM&S accounting definition. However, the Air Force did not maintain a methodology to determine how it categorizes an equipment asset as opposed to an inventory or OM&S asset. Instead, the Air Force relied on ILS-S data fields to determine if an asset was equipment or inventory and OM&S.

The Air Force should develop additional procedures over the data contained in ILS-S and its logistics readiness warehouses to determine which assets meet the equipment definition in SFFAS No. 6 and which assets meet the inventory and OM&S definition in SFFAS No. 3. Once the review is completed, the Air Force should establish guidance and internal controls to ensure they properly account for equipment assets.

- The Air Force did not have adequate controls to measure the magnitude of known inventory or OM&S assets excluded from the ILS-S while the Air Force continues investigating the proper accountability of the asset. Air Force Instruction (AFI) 23-101, "Air Force Materiel Management," requires Air Force personnel to maintain permanent warehouse locations for these assets during ongoing Air Force investigation of proper accountability. Air Force Manual 23-122, "Materiel Management Procedures," requires Air Force personnel to determine ownership of the assets and return the property to the responsible organization. One Air Force location we selected had unrecorded inventory valued at \$1.4 million because the Air Force base could not verify whether it owned the inventory. The \$1.4 million of inventory was not included in ILS-S.

Air Force logistics personnel followed Air Force procedures and regulations. However, Air Force personnel were unaware of the overall materiality of the excluded assets across the Air Force. In addition, Air Force personnel did not perform procedures to determine the pervasiveness of this potential problem and assess its materiality with respect to reported inventory and OM&S balances. Without an assessment of the materiality of these assets, there is a risk that the financial statements could be misstated.

- According to Air Force personnel, Arnold Air Force Base, Tennessee, and the U.S. Air Force Academy, Colorado Springs, Colorado, did not account for their inventory and OM&S assets, valued \$43.2 million and \$2.6 million, respectively, in the ILS-S; therefore, those assets were not included in the UoT.⁵

⁵ We did not assess the accuracy of the valuation.

Air Force logistics personnel stated that they developed a corrective action plan to include Arnold Air Force Base assets into the ILS-S, but are unsure how to manage the U.S. Air Force Academy's asset reporting because of the Academy's mission. The Air Force did not provide evidence that all other Air Force bases were included in the ILS-S, and they did not quantify the materiality of the omissions. The Air Force should determine if exclusions were occurring at other Air Force bases, determine the materiality, and verify that these assets are included for financial statement reporting.

- McEntire Air National Guard (ANG) base did not have adequate controls over hazardous materials. Specifically, instead of using the ILS-S, McEntire ANG used the Enterprise Environmental, Safety, and Occupational Health-Management Information System (EESOH-MIS) to account for national stock numbers located in the hazardous materials storage warehouse. The EESOH-MIS accounts for "free issue" assets. Air Force personnel stated that free issue is a process where an Air Force unit buys hazardous material assets, but does not consume all of the assets. Instead, any Air Force unit may consume these unused assets free of charge. AFI 32-7086 ANG Supplement, "Hazardous Materials Management," states that ANG bases should support the free issue of unused hazardous materials to minimize hazardous usage or waste. Some of the assets were free issue and the base properly accounted for them in the EESOH-MIS and ILS-S, in accordance with AFI 23-101. However, base personnel did not comply with Air Force Manual 23-122 because they did not account for standard issue hazardous materials in the hazardous materials storage warehouse in the ILS-S.

Air Force personnel agreed that the base should have used the ILS-S to report its hazardous material assets. The Air Force did not know the scope of other Air Force bases not using the ILS-S for hazardous materials. For that reason, Air Force should assess whether other bases are not using the ILS-S for these assets and should determine if the amount is material and make adjustments if necessary.

- The Air Force did not have adequate controls to ensure the logistics readiness warehouse employees had appropriately segregated assets ordered by the end user. AFI 23-101 requires warehouse personnel to take prompt action to select and prepare to ship assets ordered by a customer. In the case of 32 assets, valued at \$204,398, Air Force customers placed an order, but instead of shipping the order, the assets remained on the warehouse shelves.

In accordance with Air Force regulations, the Air Force should ensure that logistics readiness warehouse employees are properly trained to order and issue assets in a timely manner.

Improving these internal control processes will help the Air Force repeat and sustain the assertion audit readiness process during future financial statement examinations and audits. Improved internal control processes will also help the Air Force support the FY 2018 financial statement audit.

We provided a discussion draft of this report to the Office of the Secretary of the Air Force, who provided technical comments that we have incorporated as appropriate. This report is intended solely for the information and use of the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD, and the Assistant Secretary of the Air Force (Financial Management and Comptroller). This report is not intended for use by anyone else. However, this report will be made publicly available in accordance with section 8M, paragraph (b)(1)(A) of the Inspector General Act of 1978, as amended.



Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting

Appendix

This Appendix presents the results of our statistical (Table 1) and nonstatistical (Table 2) sample testing. We designed our tests to determine whether the asset listed in the UoT existed. Our auditors did not test whether the Air Force appropriately classified the asset as inventory, OM&S, or other asset types. Our existence testing results did not directly contribute to the scope limitations and internal control weaknesses identified in the body of the report. To identify the reported weaknesses, we used analytical testing of the entire population of assets, as well as tests of specific Air Force controls.

The March 31, 2017, UoT consisted of an estimated 1,596,470 national stock numbers valued at \$12.3 billion. To complete our objective and increase the efficiency of our testing, we modified the March 31, 2017, UoT before selecting a statistical sample. Specifically, we removed immaterial Air Force Major Commands and focused on high-dollar locations. In addition to assets from high-dollar locations, our revised universe included assets from smaller Air Force sites located in close geographic proximity to the high-dollar locations selected. The modified UoT included 381,792 national stock numbers totaling \$4.5 billion. We tested a statistical sample of 205 national stock number totaling \$1.1 billion from the UoT by comparing the ILS-S records to the on-hand quantities stored at selected Air Force bases.⁶ For some instances when the asset was no longer physically located at the base, we relied on other evidence to verify the asset’s existence.⁷ Our disclaimer report does not provide a projected error or propose an adjustment to the Air Force because of the significance of the two scope limitations that we identified.

Table 1. Summary of Statistical Sample Testing

	Universe	Sample
National Stock Numbers	381,792	205
Value	\$4,451,595,902	\$1,075,662,575
Projected Error	\$6,992,417*	

* We are 95 percent confident that the total dollar error is between \$974,848 and \$13,009,987 and the point estimate is \$6,992,417.

We nonstatistically selected 45 samples at each DoD activity address code for additional review. This totaled 1,258 samples from the Air Force bases. During this testing, we selected national stock numbers from each Air Force base we visited and compared the observed quantities to those reported in the ILS-S to confirm the assets were appropriately included in the accountable property system of record. Of the 1,258 samples, we found 57 exceptions where the observed quantities did not match those reported in the ILS-S.

⁶ The DoD Office of Inspector General Quantitative Methods Division statistically selected a sample of national stock numbers from the universe of Air Force Major Commands.

⁷ Some reasons the inventory and OM&S were no longer physically present was that Air Force officials had already issued the asset to the customer or had shipped the asset to another base.

We nonstatistically selected 45 samples at each DoD activity address code for additional review.⁸ This totaled 1,258 samples from the Air Force bases.⁹ During this testing, we selected national stock numbers from each Air Force base we visited and compared the observed quantities to those reported in the ILS-S to confirm the assets were appropriately included in the accountable property system of record. Of the 1,258 samples, we found 57 exceptions where the observed quantities did not match those reported in the ILS-S.

Table 2. Summary of Nonstatistical Sample Testing

	Total Tested	Passed	Exception
Site 1	45	45	0
Site 2	45	44	1
Site 3	45	44	1
Site 4	45	44	1
Site 5	44	30	14
Site 6	45	45	0
Site 7	45	40	5
Site 8	45	45	0
Site 9	45	43	2
Site 10	45	44	1
Site 11	45	44	1
Site 12	45	44	1
Site 13	45	41	4
Site 14	45	45	0
Site 15	45	44	1
Site 16	44	44	0
Site 17	45	45	0
Site 18	45	41	4
Site 19	45	44	1
Site 20	45	43	2
Site 21	45	45	0
Site 22	45	37	8
Site 23	45	42	3
Site 24	45	45	0
Site 25	45	45	0
Site 26	45	43	2
Site 27	45	43	2
Site 28	45	42	3
Total	1258	1201	57

⁸ At some bases, we did not test 45 because we had duplicate samples.

⁹ Examples of inventory and OM&S assets tested range from transmitters, actuators, and antennas to tires, oil, and batteries.



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