Audit Report

OFFICE OF THE INSPECTOR GENERAL

CENTRAL DISTRIBUTION CENTER OPERATIONS OF THE DEFENSE COMMISSARY AGENCY

Report No. 94-083 April 13, 1994

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Acronyms

CDC	Central Distribution Center
CMA	Cooperative Merchandising Agreement
DeCA	Defense Commissary Agency
DIBS	DeCA Interim Business System

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

April 13, 1994

MEMORANDUM FOR DIRECTOR, DEFENSE COMMISSARY AGENCY

SUBJECT: Audit Report on Central Distribution Center Operations of the Defense Commissary Agency (Report No. 94-083)

We are providing this report for your review and comments. The report discusses the use of earned vendor discounts to offset selected operational costs of central distribution centers, and the internal controls related to inventory management at the centers. Your March 17, 1994, comments on the draft report were considered in preparing this final report and were fully responsive to our recommendations.

DoD Directive 7650.3 requires that you state your concurrence or nonconcurrence with the estimated potential monetary benefits. Please provide an estimate of the potential monetary benefit of closing the central distribution centers over the Future Years Defense Program period by June 13, 1994. Potential monetary benefits are subject to resolution in accordance with DoD Directive 7650.3 in the event of nonconcurrence or failure to comment.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Robert J. Ryan, Program Director, at (703) 692-3457 or Mr. Timothy J. Tonkovic, Project Manager, at (804) 766-3319. Copies of the report will be distributed to the organizations listed in Appendix C. The list of audit team members is on the inside back cover of this report.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 94-083 **April 13, 1994**
(Project No. 2LA-0064)

CENTRAL DISTRIBUTION CENTER OPERATIONS OF THE DEFENSE COMMISSARY AGENCY

EXECUTIVE SUMMARY

Introduction. The Defense Commissary Agency (DeCA) operates central distribution centers (CDCs) that receive and store semiperishable and nonperishable grocery items and consumable supplies necessary to support the needs of designated commissaries. Vendors and distributors deliver their merchandise to the Government-owned and -operated CDCs where it is stored and later transported to local commissaries. Earned vendor discount agreements are negotiated to offset DeCA's cost of operating CDCs.

Since the establishment of DeCA in October 1991, DeCA has closed or is in the process of closing five CDCs due to the availability of frequent delivery services to commissaries by commercial distributors. We support this action because it results in manpower and operational savings and an improved use of resources.

Objectives. The audit objective was to evaluate the efficiency and effectiveness of methods used in the continental United States to receive and distribute commissary grocery items. We also evaluated the adequacy and effectiveness of internal controls over merchandising ordering procedures and inventories of commissary grocery items at the CDCs.

Audit Results. CDCs were not the most cost-effective method of resupplying continental United States commissaries. Potential monetary benefits could be realized if DeCA closes CDCs where frequent and direct store delivery services can adequately support commissaries and if DeCA negotiates and collects earned vendor discounts (Finding A).

Accurate inventory information was not available to CDC personnel for the reconciliation, ordering, and managing of semiperishable and nonperishable grocery items. As a result, inventory losses will not be readily identified, unnecessary high prices could be paid, and the potential for abuse exists (Finding B).

Internal Controls. Internal controls and DeCA's implementation of the DoD Internal Management Control Program were not effective to ensure that vendors had negotiated earned vendor discount agreements or that vendors were paying appropriate amounts for the use of CDCs. Additionally, weaknesses were identified in DeCA's merchandise ordering procedures and inventory accountability. See Part I for a description of the internal controls assessed and Findings A. and B. for details on the material weaknesses identified.

Potential Benefits of Audit. Potential monetary benefits of $14.7 million could be realized if the recommendations in this report are implemented (Appendix A).

Summary of Recommendations. We recommended that CDCs be closed if DeCA determines that frequent delivery service or direct store deliveries can satisfy customer requirements, earned vendor discount agreements be negotiated and collected, earned vendor discounts be retroactively collected, and guidelines be established on negotiating earned vendor discount agreements. We also recommended that DeCA conduct periodic physical inventories, investigate significant inventory variances, and enforce procedures requiring that only needed quantities of items are ordered for CDCs.

Management Comments. The Director, DeCA, concurred with the recommendation to close CDCs in favor of vendor frequent delivery. In November 1993, DeCA announced the decision to close all continental United States CDCs by January 1995. Because DeCA plans to close all continental United States CDCs, the Director did not consider it practical to establish procedures for negotiating and collecting earned vendor discounts or to negotiate enforceable vendor agreements. The Director, DeCA, will continue to aggressively pursue collection of funds owed from vendors with negotiated earned vendor discounts. Pending closure of the continental United States CDCs in January 1995, the Director, DeCA, partially agreed to conduct periodic CDC inventories, investigate inventory variances, and enforce ordering procedures. A discussion of the DeCA comments is in Part II and the complete text of the comments is in Part IV.

Audit Response. Although DeCA did not fully concur with all of our recommendations, we consider their plans to close all continental United States CDCs by January 1995, to fully satisfy the intent of our recommendations. The planned management action to close all continental United States CDCs by January 1995 is commendable and will result in manpower and operational efficiencies and an improved use of resources.

DeCA did not comment on the potential monetary benefits. Therefore, we request that the Director, DeCA, provide comments on the potential monetary benefits by June 13, 1994.

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This report was prepared by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

Part I - Introduction

Background

On March 2, 1989, the Chairman of the Morale, Welfare and Recreation Panel, Subcommittee on Readiness, House Committee on Armed Services, requested that DoD totally reassess its military commissary programs. In response, on March 31, 1989, the then Deputy Assistant Secretary of Defense (Resource Management and Support) initiated a study of the military commissaries, commonly referred to as the Jones Commission (the Commission). The Commission's report recommended that the four military commissary systems be consolidated.

The Defense Commissary Agency (DeCA) was established on October 1, 1991, to manage the consolidated commissary system. DeCA assumed responsibility for the central distribution centers (CDCs) that existed in the Navy and Marine Corps. The CDCs were responsible for the receipt, storage, accountability, issuance, and transportation of semiperishable and nonperishable grocery items and consumable supplies necessary to support the needs of designated commissaries. Commercial distributors directly deliver about 93 percent of the grocery items sold in the continental United States commissaries, and the CDCs account for the remaining 7 percent. The direct delivery by commercial distributors and CDCs have reduced the need for warehouse storage space at commissaries.

As of May 1, 1993, 11 CDCs and one remote distribution center were located in 5 Defense commissary regions in the continental United States. The remote distribution center has the same function as a CDC, but its operations and inventory are integrated with a specific commissary. At two of the CDCs (Mechanicsburg, Pennsylvania, and Tracy, California) DeCA owned the inventory and the Defense Logistics Agency (DLA) operated the facilities. The personnel costs associated with operating the CDCs are paid with appropriated funds, while the equipment, supplies and redistribution transportation costs are paid with surcharge funds.

All CDCs will eventually use the DeCA Interim Business System (DIBS) to manage their inventory levels. DIBS will also be used to monitor the ordering, receiving, and distributing of semiperishable and perishable grocery items. The DIBS had been implemented at five of the CDCs we visited.

Objectives

The audit objective was to evaluate the efficiency and effectiveness of methods used in the continental United States to receive and distribute commissary grocery items. We also evaluated the adequacy and effectiveness of internal controls over merchandising ordering procedures and commissary resale stock inventories at the CDCs.

Scope and Methodology

Audit Coverage. We visited nine CDCs in five continental United States Defense commissary regions and the remote distribution center at Great Lakes, Illinois, and reviewed procedures for ordering, receiving, storing, and issuing items. We selected a sample of grocery items at the CDCs and physically inventoried and reconciled the inventory counts to the CDCs' book inventories. At the regions, we documented DeCA's policies on earned vendor discount agreements and determined the extent of collections received from negotiated vendor agreements.

Cost of Operations. To determine CDC operational costs, we reviewed civilian pay, military pay and benefits, travel expenses, commercial activity contracts, and general and administrative costs. We also reviewed costs for supplies, equipment, transportation, and utilities. The operational costs for the remote distribution center at Great Lakes, Illinois, could not be determined because they were consolidated with the Great Lakes commissary costs.

Universe and Sample. At the CDCs that maintained significant line item inventories (375 or more line items), we randomly selected a representative sample of grocery items for a physical inventory count and reconciliation to the inventory records located in DIBS or other automated systems. At CDCs with a smaller number of line items, we performed a 100-percent physical inventory count and reconciliation. We did not include consumable supply items, such as paper and plastic bags, in our physical counts. The results of our evaluation of the computer processed data are discussed in Finding B.

Audit Period, Locations and Standards. The audit was performed from September 1992 through May 1993 and included reviews and tests of records for the period October 1991 through April 1993. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD, and accordingly included such tests of internal controls as were considered necessary. Organizations visited or contacted during the audit are in Appendix B.

Internal Controls

Internal Controls Reviewed. We reviewed implementation of the DoD Internal Management Control Program involving the DeCA CDCs. Our review included an evaluation of written policies and procedures on earned vendor discount agreements, merchandise ordering procedures by the CDCs, and inventory accountability at the CDCs.

Internal Control Weaknesses Identified. The audit identified material internal control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987 DeCA had not report any control weaknesses related to CDCs, because it had not implemented the DoD

Internal Management Control Program at the CDC level or established reliable internal controls to ensure that vendors had negotiated earned vendor discount agreements or that vendors were paying appropriate amounts for the use of CDCs. Additionally, inventory controls were not in place at four of the five CDCs, using DIBS for inventory management, to ensure appropriate tracking of inventory and to prevent employees from making inventory adjustments before reconciling and investigating inventory differences. Recommendations A.2., B.1., and B.2., if implemented, will correct the weaknesses. No quantifiable monetary benefits were associated with correcting the internal control weaknesses. Appendix A summarizes the potential benefits from the audit. A copy of the report will be provided to the senior official responsible for internal controls within the Office of the Secretary of Defense and DeCA.

Prior Audits and Other Reviews

There have been no prior audits in the last 5 years addressing the efficiency and effectiveness of procedures used in continental United States for the receipt and distribution of commissary grocery items.

Other Matters of Interest

Shortly after the establishment of DeCA, the CDCs in Philadelphia, Pennsylvania, and Corpus Christi, Texas, were closed. During 1993, the Defense commissary southern and central regions notified DeCA Headquarters of their intent to close three additional CDCs. The regions justified closing the Charleston, South Carolina; Pensacola, Florida; and Norfolk, Virginia, CDCs because of the low number of line items and the increased availability of frequent delivery services to commissaries. The action will result in manpower and operational efficiencies and an improved use of resources.

Part II - Findings and Recommendations

Finding A. Central Distribution Center Operations

The central distribution centers were not the most cost-effective method of resupplying continental United States commissaries. The condition occurred because the Defense Commissary Agency continued to operate central distribution centers where direct store and frequent delivery service were available, and the Defense Commissary Agency did not negotiate and collect earned vendor discounts sufficient to offset selected central distribution center operational costs. Additionally, the Defense Commissary Agency improperly applied payments from cooperative merchandising agreements as earned vendor discounts. As a result, $14.7 million could be put to better use if the Defense Commissary Agency closes central distribution centers where direct store and frequent delivery services can adequately resupply commissaries and negotiates and collects earned vendor discounts.

Background

The three methods used to deliver items to continental United States commissaries are frequent delivery service, direct store delivery, and CDCs. Frequent delivery service provides for items to be electronically ordered from a vendor or distributor and periodically delivered directly to the commissaries. Through direct store delivery, vendor representatives determine order quantities and deliver and stock the items directly on the commissaries' shelves. An example of this is the daily delivery of bread and milk. CDCs purchase semiperishable and nonperishable grocery items and consumable supply items from vendors, warehouse the items, and distribute them to commissaries. CDCs usually support commissaries within a specific geographic area and stock between 370 and 2,200 line items. DeCA's policy is for CDCs to maintain a 21-day inventory level of stocked items, which includes a 14-day operating stock level, and a 7-day safety level.

When frequent delivery and direct store delivery services support individual commissaries, vendors include their transportation and storage costs in the billing price for the item. Conversely, vendors incur less transportation and storage costs when deliveries are made to a CDC for storage and eventual redistribution to commissaries. DeCA furnished receipt, storage, and redistribution (secondary) transportation services for vendors using CDCs. The costs for CDC services were not passed on to DeCA's customers as higher priced items, but instead were paid with appropriated and surcharge funds.

DeCA determined that individual vendors using CDCs should help offset CDC operating costs by making payments to DeCA based on a negotiated agreement. These agreements, called earned vendor discounts, reimburse DeCA a negotiated amount based on the number of cases or the value of line items handled by the CDCs.

On January 24, 1992, DeCA issued a notice to the trade (a written process used by DeCA to inform commercial vendors of DeCA policies and guidelines), which established the earned vendor discount policy. The notice to the trade stated that DeCA regional directors or commanders were to negotiate earned discount agreements with vendors who use the CDCs. To obtain fair and reasonable discount rates for each CDC, the earned vendor discount rate was to be negotiated on a regional basis.

Criteria

On February 28, 1992, DeCA issued a memorandum containing specific guidance on earned vendor discount agreements to its regional resource managers. The guidance states that:

o Earned discounts are to be collected quarterly, based on the negotiated agreements and a list of deliveries in support of the amount paid.

o Earned discount payments are to be deposited in the DeCA Surcharge Collections Fund.

o Payments and deliveries are to be reconciled to determine whether proper payment is received. When a discrepancy exists, resolution is to be effected.

DeCA Directive 40-23, "Central Distribution Center Procedures," October 30, 1992, provides guidance for establishing and operating a CDC. It requires centralized stockage of semiperishable and nonperishable grocery items and consumable supply items that used to be stocked in commissary warehouses of the Military Departments. The Directive also requires payment (earned vendor discounts) from vendors using the Government-owned and -operated CDCs for storage and shipment of their product to commissaries. Those payments are required to offset the cost of operating the CDCs. The commissary regions in which the CDCs are located are required to negotiate earned vendor discount agreements with each vendor. Payments from vendors are to be deposited into the transportation category of the DeCA Surcharge Collections Fund account.

Distribution Methods

CDCs were not the most cost-effective method of providing support to commissaries. Direct store delivery and frequent delivery service, where available, were more economical because they provided delivery service at no additional cost to the Government or the commissary customer. DeCA continued to operate CDCs because it had not established a policy and procedures to identify and close nonessential CDCs where commercial delivery services were able to satisfy the demands of commissaries.

We visited five DeCA regions using CDCs, and found that direct store and frequent delivery services were available in all or parts of the regions. However, the number of frequent delivery vendors and the level of DeCA's reliance on their services varied by region. The Southern and the Central regions planned to close CDCs through the effective development of direct store and frequent delivery service. In contrast, the Northeast and Southwest regions expanded the use of CDCs and did not encourage vendors to decrease their reliance on the government provided service.

In addition to not using the most cost-effective method of providing support to commissaries, the regions with CDCs were not negotiating and collecting earned vendor discounts to offset the operating costs.

Earned Vendor Discounts

During our audit, only three of the five DeCA regions with CDCs had negotiated earned vendor discount agreements. Further, at those three regions, agreements had only been negotiated with 99 (64 percent) of the CDC-using vendors and DeCA did not always collect from those vendors with negotiated earned vendor discount agreements. Had DeCA enforced its earned vendor discount program and formalized collection procedures, it could have operated CDC's more economically.

Operating Costs. DeCA did not negotiate and collect a sufficient amount of earned vendor discounts to offset selected CDC operating costs. We visited five DeCA regions and estimated that the FY 1992 cost to operate nine CDCs was $14.7 million. The $14.7 million in operating costs consisted of $5.5 million in DeCA Surcharge Collection Funds and $9.2 million in appropriated Operation and Maintenance funds. Of the appropriated Operation and Maintenance funds, $1 million was paid to the Military Departments for military personnel assigned to the CDCs. Total operating costs, by CDC, are shown in Table 1.

Table 1. FY 1992 CDC Operating Costs

Location	Costs
Cameron Station, VA	$ 1,789,227
El Toro, CA	1,514,034
Ft. Lewis, WA	1,945,106
Jacksonville, FL	1,995,230
Mechanicsburg, PA	1,931,399
Newport, RI	1,121,035
Norfolk, VA	1,954,388
Pensacola, FL	265,400
San Diego, CA	2,229,665
Total	$14,745,484

DeCA did not collect any earned vendor discounts during FY 1992 to offset the $14.7 million in operating costs. However, as of April 30, 1993, DeCA had collected a total of $1.4 million in earned vendor discounts for the nine CDCs.

Earned Vendor Discount Negotiations. DeCA did not negotiate earned vendor discount agreements with all vendors using the CDCs, as required by DeCA Directive 40-23. Table 2. shows the number of vendors using the CDCs in each region and the number of negotiated earned vendor discount agreements.

Table 2. Number of CDC Vendors with Negotiated Earned Vendor Discount Agreements

Region	Number of Vendors	Negotiated Agreements	Percent Negotiated
Central	15	0	0
Northeast	18	16	89
Northwest	55	37	67
Southern	10	0	0
Southwest	57	46	81
Total	155	99	64

Vendors using CDCs are supported by a Government-owned, -operated, and -controlled centralized warehouse for the delivery, storage, and issuance of their merchandise. As such, the regions should negotiate agreements with all vendors to reimburse DeCA for the services provided to them. To prevent an unfair advantage to vendors using CDCs and to reduce DeCA operating costs, earned vendor discounts should be negotiated to sufficiently offset transportation and other CDC operational support cost.

Earned Vendor Discount Collections. DeCA had not formalized procedures to collect amounts due from CDC vendors with negotiated earned vendor discount agreements. Additionally, DeCA had not established procedures to retroactively collect amounts due from vendors. Table 3. shows the number of CDC-using vendors with negotiated agreements, and the number of vendors paying earned vendor discounts, as of April 30, 1993.

Table 3. Vendors Participating In DeCA's Earned Vendor Discount Program

Region	Negotiated Agreements	Vendors Paying	Percent Paying
Central	0	0	0
Northeast	16	6	38
Northwest	37	15	41
Southern	0	0	0
Southwest	46	13	28
Total	99	34	34

Approximately one-third of the vendors with earned vendor discount agreements were paying DeCA at the time of our audit. Since documentation was not available showing negotiated amounts owed, we were unable to determine if vendors were making full payment. DeCA had not formalized any procedures to collect the negotiated earned vendor discount amounts due. Additionally, no procedures existed to collect overdue balances from vendors with negotiated agreements.

Cooperative Merchandising Agreements

DeCA permitted the largest user of CDCs to use a cooperative merchandising agreement (CMA) as a substitute for an earned vendor discount agreement. As a result, DeCA improperly applied CMA payments as earned vendor discounts.

A CMA is an agreement between the vendor and DeCA for payment of funds for items prominently displayed off-the-shelf (usually an end of aisle display) for a specified period. The purpose of prominent off-the-shelf displays of a specific product is to promote a vendor's product and provide increased sales to that vendor. In return, the vendor pays DeCA an amount, as negotiated in the CMA.

On July 31, 1992, the DeCA Operations Directorate issued guidance stating that CMA payments to DeCA are to be used for item price reductions or customer support issues. Customer support issues include in-store promotions, contests, or other customer benefits. DeCA was using a portion of the CMA payments as

an earned vendor discount. The use of a CMA instead of an earned vendor discount is not enforceable, can provide a vendor with an unfair competitive advantage, and has resulted in DeCA not collecting equitable amounts due for the use of CDCs.

In June 1992, the DeCA General Counsel found that CMAs, as used by the largest user of CDCs, may violate a DeCA policy prohibiting the endorsement of brands, and that a CMA is not legally sufficient to serve as an earned vendor discount agreement. The DeCA General Counsel further stated:

> DeCA should develop its own agreement which would set out the terms DeCA requires to obtain sufficient discounts to reimburse DeCA for transportation costs from the CDC to the stores.

By allowing the largest CDC-using vendor to use CMAs instead of an earned vendor discount, DeCA received payments for endorsing a vendor's product, rather than payments to offset CDC operational costs.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Director, Defense Commissary Agency determine those geographic areas where commercial delivery services can adequately support commissary requirements and close central distribution centers; or negotiate and collect earned vendor discounts to significantly offset operational costs in those areas where central distribution centers are a necessary method of storage and delivery.

Management Comments. The Director, DeCA, concurred with the recommendation and stated that DeCA will discontinue the use of continental United States CDCs in favor of vendor frequent delivery. Some CDCs may close as early as September 1994, and all continental United States CDCs will close by January 1995. The full text of management's comments is in Part IV.

Audit Response. We consider DeCA's comments to be responsive to the intent of the recommendation. However, DeCA did not comment on the potential monetary benefits of $14.7 million resulting from the closure of continental United States CDCs. Therefore, we request that the Director, DeCA provide comments on the reported potential monetary benefits by June 13, 1994.

2. We recommend that the Director, Defense Commissary Agency establish procedures and controls for timely negotiation and collection of earned vendor discounts.

Management Comments. The Director, DeCA, partially concurred with the recommendation. Because DeCA is planning to close all continental United States CDCs, DeCA did not consider it practical to establish procedures and controls for timely negotiation and collection of earned vendor discounts.

Audit Response. In view of DeCA's plans to close the continental United States CDCs by January 1995, we consider DeCA's comments to be responsive to the recommendation.

3. We recommend that the Director, Defense Commissary Agency, retroactively collect earned vendor discounts from central distribution center vendors that have negotiated agreements with the Defense Commissary Agency.

Management Comments. DeCA concurred with the recommendation, and stated that DeCA Policy Letter 70-36, was issued in September 1993 and included provisions for monitoring and tracking vendor discounts earned, the amount DeCA received as payments for discounts earned, and follow-up collection actions for discounts earned but payments not received.

4. We recommend that the Director, Defense Commissary Agency, negotiate enforceable vendor agreements with the largest vendor using central distribution centers, based on the number of cases or the value of the line items handled by the central distribution centers.

Management Comments. In view of its plans to close the continental United States CDCs by January 1995, DeCA nonconcurred with the recommendation, stating that it was not considered practical to negotiate enforceable vendor agreements for vendors using CDCs.

Audit Response. Although DeCA nonconcurred with the recommendation, we consider its proposed action responsive to the recommendation.

Finding B. Inventory Management at Central Distribution Centers

Inventory information at the central distribution centers was not accurate for reconciling, ordering, and managing semiperishable and nonperishable grocery items. The condition occurred because controls were not in place to ensure the complete recording of inventory storage locations and to prevent unreconciled inventory adjustments. Additionally, internal controls were not effective to make sure that the Defense Commissary Agency did not unnecessarily pay a higher price for central distribution center items than they were ultimately sold for in the commissaries. As a result, inventory losses will not be investigated, unnecessary high prices will be paid, and the potential for abuse exists.

Background

Of the nine CDCs we visited, five used DIBS to manage their inventory levels and for ordering, receiving, and distributing semiperishable and perishable grocery items. DeCA plans to convert all CDCs to DIBS within the next fiscal year. DIBS will permit CDC personnel to record inventory balances and locations and based on that data, CDC personnel will be able to process orders for CDC stock replenishment.

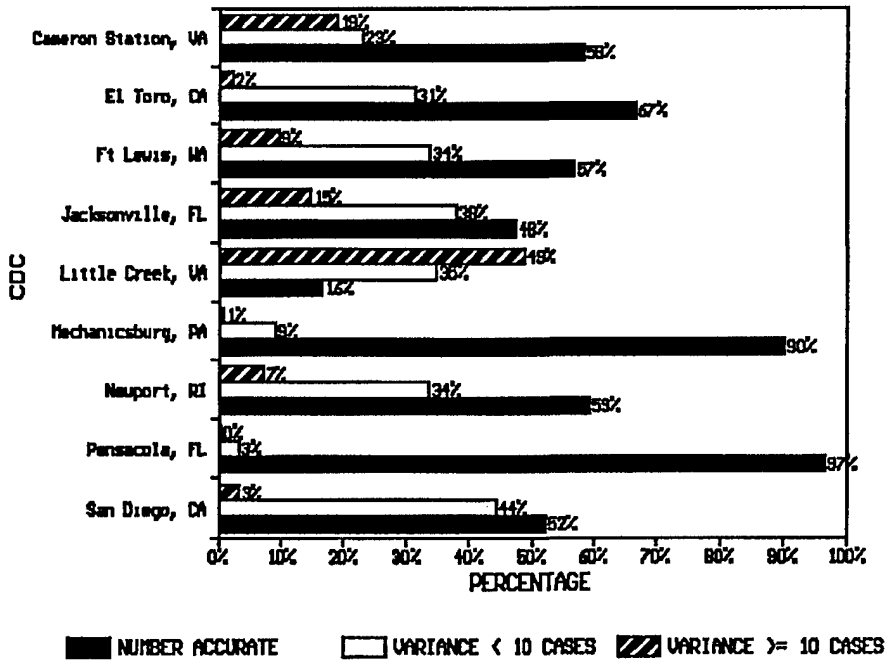
Inventory Controls

CDC Inventory. Inventory information at the CDCs was not accurate for reconciling, ordering, and managing semiperishable and nonperishable grocery items. We performed physical inventory counts for 2,552 line items, valued at about $6 million, at 9 CDCs. We were unable to test the stock items at the Great Lakes remote distribution center because the inventory values were included in the overall inventory of the Great Lakes commissary. We reconciled the physical count balances to the CDC book inventories (maintained in DIBS and other automated systems) for the 2,552 line items tested, and noted that:

- 1,573 (62 percent) line items were accurately recorded on CDC inventory records,
- 698 (27 percent) line items had a variance of less than 10 cases, and
- 281 (11 percent) line items had a variance of more than 10 cases.

Individual statistics for the nine CDCs are shown in the figure below.

CDC Inventory Results



In summary, there was an inventory variance for 38 percent of the line items. For the items inventoried, the net value of the variances represented a shortage of $267,159 (4.5 percent) and the absolute value of the variances was $749,714 (13 percent).

Inventory Storage Locations and Adjustments. CDC inventory variances occurred because controls were not in place to ensure the reporting of all inventory locations and to prevent unreconciled inventory adjustments. Additionally, variances went undetected because there was no separation of duties for authorizing, processing, reporting, and reviewing the CDC inventory transactions.

At CDCs that used DIBS to control physical inventories, each line item was assigned a five-digit warehouse location code. DIBS allows up to three warehouse locations (primary and secondary) per inventory line item. Only one of the five CDCs using DIBS for inventory control included primary and secondary location codes for items stored in the CDC warehouse. The inventory variance for the CDC was less than 10 percent. The remaining four CDCs using DIBS did not track secondary line item warehouse locations (other than personal recollection). The average inventory variance for the four CDCs was 41 percent.

The failure to track secondary line item warehouse locations contributed to the misstatements of inventory balances noted at the CDCs. For instance, at the

CDC in San Diego, California, a variance equal to one pallet was found for an inventory item. The item was located in several areas in the warehouse. Warehouse personnel, not knowing all of the storage locations, missed the pallet when conducting a physical inventory of the product. If multiple warehouse locations had been tracked in DIBS, this error might not have occurred.

Another explanation for the variances between the CDC book inventories and the inventory counts we performed at the five CDCs using DIBS was that CDC personnel were routinely adjusting the DIBS on-hand inventory balances without an appropriate investigation of differences between the physical counts and the DIBS reported balances. Investigation of differences should be promptly performed to determine the causes for the variance, including the possible theft of items. When CDC personnel conducted physical inventory counts on warehouse items, they adjusted DIBS to reflect the on-hand balances resulting from the physical count. CDC personnel were not required to justify or document adjustments made to the DIBS on-hand inventory balance. Further, the individuals performing the physical inventories were the same individuals making adjustments to the DIBS.

The net value of the inventory variances represented a shortage of 4.5 percent for the items we inventoried. The total inventory variance for all items in the CDCs could be significantly higher. The lack of an audit trail documenting the adjustments to the DIBS on-hand inventory balance could prevent the detection of the inventory variances. In addition, the cause of the variance could not be determined.

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, states that key duties and responsibilities should be assigned so that no one individual controls all phases of an activity or transaction. Changes to the on-hand inventory amounts should be performed and validated, by personnel who are independent of the daily CDC operations, after adequate research of the reported differences is performed and documentation justifying the change is prepared.

CDC Ordering. CDCs were vulnerable to unnecessary losses by ordering items at higher prices than what the items would be sold for in the commissary. This occurred because DeCA personnel did not monitor the accuracy, need, and price of product orders.

Region and CDC personnel order CDC items on a reoccurring basis, usually once a week. The ordered items are delivered to the CDC at a predetermined time and date. Because vendors were usually more familiar with product sales' histories, several DeCA regions relied on vendor recommendations for the items and quantities to be ordered for delivery to the CDCs.

An opportunity existed for vendors to recommend items and quantities, which would cause DeCA to pay higher prices for items than what the items were ultimately sold for in the commissaries. DeCA policy allowed vendors to change retail prices on grocery items once a month and occasionally twice a month. New prices became effective on the 1st and 15th of each month, with the majority of the price changes occurring on the 1st of each month. The

potential for abuse existed because vendor representatives, with the knowledge that a price reduction would become effective the following month, could recommend a large quantity of the item to be ordered for the CDC in the current month in anticipation of increased sales. The CDC paid the higher price in effect at the time of the order, although the item would sell for a lower price the following month. For example, only 1 day before a price reduction took effect, laundry detergent was ordered at $5.29 per unit. At delivery, the sales price of the laundry detergent was $3.99 per unit. Because the purchase price was $5.29 per unit and the sales price was $3.99, the CDC incurred a loss of about $2,000 on the order.

DeCA personnel did not monitor CDC gains and losses that resulted from price changes. DeCA personnel stated that price changes were not monitored because of the perception that gains and losses offset each other. However, a potential for material financial losses exists. Unnecessary financial losses and the potential for abuse will continue to exist if DeCA does not implement procedures to minimize the effect of price changes on products distributed by CDCs.

With the full implementation of DIBS and knowledge of pending price reductions, regional personnel could monitor the accuracy, need and price of product orders. The DIBS provides inventory balances which could be used to validate the need for the quantity to be ordered. Additionally, with knowledge of pending price changes, the regions could determine the appropriate time to order to reduce losses on ordered items.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Director, Defense Commissary Agency establish inventory management procedures that include periodic physical inventories and investigations of significant line-item variances and require a separation of duties for the authorizing, processing, and recording of inventory transactions.

Management Comments. DeCA partially concurred with the recommendation. DeCA did not consider it practical to establish procedures for detection and investigation of line item variances because of the plans to close the continental United States CDCs by January 1995. However, DeCA will continue to exercise practical security procedures to prevent and detect inventory losses. The complete text of managements' comments is in Part IV.

Audit Response. We consider DeCA's comments to be responsive to the recommendation. DeCA plans to close all continental United States CDCs by January 1995, and agree that it would not be practical to establish formal inventory management procedures.

2. We recommend that the Director, Defense Commissary Agency develop internal control procedures:

a. that require DeCA personnel to monitor the accuracy, need, and price of product orders that are recommended by CDC-using vendors;

b. to monitor the CDC gains and losses to ensure that controls are effective.

Management Comments. DeCA partially concurred with the recommendation, commenting that with the closure of continental United States CDCs, it did not consider it practical to establish formal procedures for monitoring orders. However, DeCA will monitor orders to ensure that quantities being requested are reasonable and the quantity is actually needed.

Audit Response. Because DeCA plans to close all continental United States CDCs by January 1995, we consider DeCA's comments responsive to the overall intent of the recommendation.

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Part III - Additional Information

Appendix A. Summary of Potential Benefits Resulting from Audit

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
A.1. and A.2.	Economy and Efficiency. Closing CDCs or negotiating and collecting earned vendor discounts will significantly offset the cost of operations.	Funds put to better use. $14.7 million consisting of $9.2 million in appropriated Operation and Maintenance funds (97X4930.5J00) and $5.5 million in nonappropriated Surcharge Collection funds (97X8164.6400).
A.2.	Internal Control. Will provide a mechanism for collecting earned vendor discounts, and obtaining a full accounting of amounts owed.	Nonmonetary.
A.3.	Economy and Efficiency. Collects earned vendor discounts currently negotiated.	Funds put to better use. Monetary benefit undetermined. It is unknown how many vendors will retroactively pay DeCA's earned vendor discount.
A.4.	Economy and Efficiency. Use of negotiated agreements will ensure collection of funds to offset selected CDC operational costs.	Undetermined*

* Amount of funds put to better use will be determined if DeCA does not close CDCs as planned in January 1995. If CDCs close, then no potential monetary benefits will be realized; however, the closing of CDCs will result in manpower and operational efficiencies and an improved use of resources.

B.1.	Internal Control. Safeguards CDC inventories against waste, loss, unauthorized use and misappropriation.	Nonmonetary.
B.2.	Internal Control. Assists DeCA personnel in maintaining only needed inventories at CDCs. Will also ensure DeCA pays the lowest price for semiperishable and nonperishable grocery items and consumable supplies.	Nonmonetary.

Appendix B. Organizations Visited or Contacted

Office of the Secretary of Defense

Office of the Secretary of Defense, Washington, DC
Comptroller of the Department of Defense, Washington, DC

Defense Organizations

Defense Commissary Agency Headquarters, Ft. Lee, Petersburg, VA
Defense Commissary Agency, East Service Center, Ft. Lee, Petersburg, VA
Defense Commissary Central Region, Little Creek Naval Amphibious Base, Little Creek, VA
- Chicago Remote Distribution Center, Great Lakes, IL
- Fort Eustis, Commissary Resale Store, Fort Eustis, VA
- Fort Lee, Commissary Resale Store, Fort Lee, VA
- Fort Sheridan, Commissary Resale Store, Fort Sheridan, WI
- Great Lakes, Commissary Resale Store, Great Lakes, IL
- Langley Air Force Base, Commissary Resale Store, Hampton, VA
- Little Creek Naval Amphibious Base, Commissary Resale Store, Little Creek, VA
- Norfolk Naval Base, Commissary Resale Store, Norfolk, VA
- Oceana Naval Air Station, Commissary Resale Store, Virginia Beach, VA
- Tidewater Central Distribution Center, Norfolk, VA

Defense Commissary Northeast Region, Fort Meade, MD
- Cameron Station, Commissary Resale Store, Alexandria, VA
- Fort Belvoir, Commissary Resale Store, Fort Belvoir, VA
- Mechanicsburg Central Distribution Center, Mechanicsburg, PA
- Military District of Washington Central Distribution Center, Cameron Station, VA
- New England Central Distribution Center, Newport, RI

Defense Commissary Northwest/Pacific Region, Fort Lewis, WA
- Bangor Naval Submarine Base, Commissary Resale Store, Silverdale, WA
- Fort Lewis, Commissary Resale Store, Fort Lewis, WA
- McChord Air Force Base, Commissary Resale Store, Tacoma, WA
- Puget Sound Naval Station, Commissary Resale Store, Bremerton, WA
- Seattle-Tacoma Central Distribution Center, Ft. Lewis, WA

Defense Commissary Southern Region, Maxwell Air Force Base, Montgomery, AL
- Eglin Air Force Base, Commissary Resale Store, Valpariso, FL
- Gold Coast Central Distribution Center, Jacksonville Naval Air Station, Jacksonville, FL
- Hurlburt Field, Commissary Resale Store, Hurlburt Field, FL

Defense Organizations (cont'd)

Jacksonville Naval Air Station, Commissary Resale Store, Jacksonville, FL
Maxwell Air Force Base, Commissary Resale Store, Montgomery, AL
Mayport Naval Station, Commissary Resale Store, Atlantic Beach, FL
Panhandle Central Distribution Center, Pensacola, FL
Pensacola Naval Air Station, Commissary Resale Store, Pensacola, FL
Whiting Field, Commissary Resale Store, Milton, FL
Defense Commissary Southwest Region, Marine Corps Air Station, El Toro, CA
El Toro Marine Corps Air Station, Commissary Resale Store, Santa Ana, CA
Imperial Beach Naval Air Station, Commissary Resale Store, Imperial Beach, CA
Marine Corps Base Camp Pendleton, Commissary Resale Store, Camp Pendleton, CA
March Air Force Base, Commissary Resale Store, Riverside, CA
National City Central Distribution Center, San Diego, CA
North Island Naval Air Station, Commissary Resale Store, San Diego, CA
Orange County Central Distribution Center, El Toro, CA
San Diego Naval Station, Commissary Resale Store, San Diego, CA
San Diego Naval Training Center, Commissary Resale Store, San Diego, CA
San Onofre, Commissary Resale Store, Camp Pendleton, CA
Defense Subsistence Office, Jacksonville, FL

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
Under Secretary of Defense (Personnel and Readiness)
Assistant to the Secretary of Defense for Public Affairs
Comptroller of the Department of Defense

Department of the Army

Secretary of the Army
Auditor General

Department of the Navy

Auditor General, Naval Audit Service

Department of the Air Force

Auditor General, Air Force Audit Agency

Defense Agencies

Director, Defense Commissary Agency
Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, Defense Logistics Studies Information Exchange
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
U.S. General Accounting Office
- National Security and International Affairs Division, Technical Information Center
- National Security and International Affairs Division, Defense and National Aeronautics and Space Administration Management Issues
- National Security and International Affairs Division, Military Operations and Capabilities Issues

Non-Defense Federal Organizations (cont'd)

Chairman and Ranking Minority Member of each of the following Congressional Committees and Subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Panel on Morale, Welfare and Recreation; Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations

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Part IV - Management Comments

Defense Commissary Agency Comments

DEFENSE COMMISSARY AGENCY
HEADQUARTERS
FORT LEE, VIRGINIA 23801-6300

REPLY TO
ATTENTION OF

MAR 17 1994

IR

MEMORANDUM FOR INSPECTOR GENERAL, LOGISTICS SUPPORT DIRECTORATE, 400 ARMY NAVY DRIVE, ARLINGTON, VA 22202-2884

SUBJECT: Audit Report on Central Distribution Center Operations of the Defense Commissary Agency (Project No. 2LA-0064)

Reference: DoDIG Memorandum, dtd January 20, 1994, SAB.

Attached is the DeCA reply to the recommendations provided in subject report. If you have any questions, please contact Mr. Ben Mikell at (804) 734-8103.

RICHARD E. BEALE, JR.
Major General, USA
Director

Attachments:
As Stated

DEFENSE COMMISSARY AGENCY REPLY

SUBJECT: Audit Report on Central Distribution Center Operations of the Defense Commissary Agency (Project No. 2LA-0064)

FINDING A: Central Distribution Center Operations

Recommendation A-1. Determine those geographic areas where commercial delivery services can adequately support commissary requirements and close central distribution centers (CDC); or negotiate and collect earned vendor discounts to significantly offset operational costs in those areas where CDCs are a necessary method of storage and delivery.

Action Taken. Concur. In November 1993, DeCA announced the decision to discontinue the use of CDCs in favor of Vendor Frequent Delivery. As vendors that are currently using the CDC convert to a new supply method, some CDCs may close as early as September 1994. All CONUS CDCs will close by January 1995.

Recommendation A-2. Establish procedures and controls for timely negotiation and collection of earned vendor discounts.

Action Taken. Partially concur. Since DeCA is discontinuing CDC operations, it is not considered practical to establish procedures and controls for timely negotiation and collection of earned vendor discounts. However, efforts will continue to be taken to collect the money due to DeCA.

Recommendation A-3. Retroactively collect earned vendor discounts from CDC vendors that have negotiated with DeCA.

Action Taken. Concur. DeCA Headquarters developed procedures to process vendor discounts earned (Transportation Discounts) (Policy Letter 70-36) in September 1993 which includes provisions for monitoring and tracking of vendor discounts earned (Transportation Discounts), the amount DeCA has received as payments for discounts earned, and follow-up collection actions for discounts earned but payments not received by DeCA from vendors. DeCA has and will aggressively pursue collection of funds owed from vendor discounts earned.

Recommendation A-4. Negotiate enforceable vendor agreements with the largest vendor using CDCs, based on the number of cases or the value of the line items handled by the CDCs.

Action Taken. Nonconcur. Since it has already been announced that CDCs will be closing, it is not considered practical to negotiate enforceable vendor agreements for vendors using CDCs as this would signal a change in the decision to close the CDCs.

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FINDING B: Inventory Management at Central Distribution Centers

Recommendation B-1. Establish inventory management procedures that include periodic physical inventories and investigations of significant line-item variances and require a separation of duties for the authorizing, processing, and recording of inventory transactions.

Action Taken. Partially concur. Since DeCA is discontinuing CDC operations, it is not considered practical to establish procedures for detection and investigation of line item variances. However, DeCA will continue to exercise practical security procedures to prevent and detect losses.

Recommendation B-2. Develop internal control procedures:

a. that require DeCA personnel to monitor the accuracy, need, and price of product orders that are recommended by CDC-using vendors;

b. to monitor the CDC gains and losses to ensure that controls are effective.

Action Taken. Partially concur. Since DeCA is discontinuing CDC operations, it is not considered practical to establish formal procedures for monitoring orders being placed to detect practices of ordering large quantities of merchandise where the selling price will be decreasing. However, DeCA will continue to monitor orders to ensure that quantities being requested are reasonable and the quantity is actually needed. In February 1993, DeCA developed and implemented procedures to monitor the CDC/store gains and losses and implemented internal controls to ensure these procedures were followed and were effective.

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Audit Team Members

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