



OFFICE OF THE UNDER SECRETARY OF DEFENSE

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COMPTROLLER

MEMORANDUM FOR ASSISTANT SECRETARIES OF THE MILITARY DEPARTMENTS
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES
DIRECTOR, JOINT STAFF

SUBJECT: Accounting Policy Update for the Expense Recognition of Operating Materials and Supplies

This memorandum establishes policy guidelines for the use of the Consumption and Purchases Methods of accounting for Operating Materials and Supplies (OM&S) and provides additional clarification on when to expense OM&S reported under the Consumption Method.

The guidance for the expense recognition of OM&S in the DoD Financial Management Regulation (FMR) is being expanded to include a framework for evaluating three exceptions under which Federal entities may expense OM&S using the Purchases Method of accounting rather than the Consumption Method. These three exceptions, as defined in Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," are that: (1) the OM&S are not significant amounts, (2) the OM&S are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the Consumption Method of accounting. The current guidance in the DoD FMR is limited, and DoD components have sought additional clarification regarding how to determine whether an amount is significant and what constitutes an end user. This memorandum, along with its attachment, expands the DoD FMR policy for expense recognition of OM&S. The relevant portions of this policy will be included in the next DoD FMR update.

If needed, please reach Mr. Brian Sykes, my point of contact for this subject, at 703-695-5902 or brian.a.sykes4.civ@mail.mil.

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Deputy Chief Financial Officer

Attachment:
As stated

cc:
Deputy Chief Management Officer
Principal Deputy Under Secretary of Defense for Acquisition, Technology and Logistics
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Assistant Secretary of the Navy (Research, Development and Acquisition)
Assistant Secretary of the Air Force (Acquisition)
Deputy Inspector General for Auditing, DoD Office of Inspector General

**Department of Defense
Expense Recognition of Operating Materials and Supplies
September 2015**

I. INTRODUCTION

Objective

The objective of this document is to provide a Department of Defense-wide framework for determining the acceptability of using the Purchases or Consumption Methods of accounting for Operating Materials and Supplies (OM&S). The framework can also be used to determine the point in the supply chain at which OM&S can be expensed under the Consumption Method. The framework was developed to meet three criteria in descending order of importance:

1. Compliance with Generally Accepted Accounting Principles (GAAP);
2. Cost- and time-effectiveness; and
3. Consistent implementation across the Department of Defense (DoD).

Background

The Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," states that "the consumption method of accounting for the recognition of expenses shall be applied for operating materials and supplies." The Consumption Method requires that OM&S "shall be recognized and reported as assets when produced or purchased." The alternative to the Consumption Method is the Purchases Method, where by OM&S is expensed upon purchase. The Purchases Method can be used if one of three criteria is met:

1. The OM&S are not significant amounts;
2. The OM&S are in the hands of the end user for use in normal operations; or
3. It is not cost-beneficial to apply the Consumption Method.

Applicable Accounting and Reporting Requirements/Guidance

- SFFAS No. 3, "Accounting for Inventory and Related Property"
- Government Accountability Office (GAO), Financial Audit Manual
- DoD Financial Management Regulation 7000.14-R Volume 4, Chapter 4
- DoD Manual (DoDM) 4140.01, "DoD Supply Chain Materiel Management Procedures"
- April 2015 Financial Improvement and Audit Readiness Guidance

Scope

This document applies to Department owned OM&S. The SFFAS 3 definition of OM&S is "tangible personal property to be consumed in normal operations." Excluded from the scope of this document are: 1) goods that have been acquired for use in constructing real property or in assembling equipment to be used by DoD components, 2) stockpile materials, 3) goods held under price stabilization programs, 4) foreclosed property, 5) seized and forfeited property, and 6) inventory.

II. OM&S EXPENSE RECOGNITION CRITERIA

This section provides a framework for evaluating the three criteria that allow for the use of the Purchases Method of accounting or for determining the point in the supply chain at which OM&S should be expensed when using the Consumption Method. While each criterion will be explained individually, the following general rules apply to all three criteria:

- This framework is not intended to replace or omit existing logistics, supply chain, or asset management requirements.
- The OM&S under consideration should be viewed in aggregate. Each location or National Item Identification Number being considered may not be significant when assessed individually, but could still be significant when taken as a whole.
- Analyses and conclusions performed by DoD components to support a particular position should be documented. The documentation should be retained in such a way that it can be easily presented to an auditor.

Criterion 1: *The OM&S are not significant amounts*

Materiality is defined in the GAO Financial Audit Manual as “the magnitude of an item’s omission or misstatement in a financial statement that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.”

Significant amounts are those amounts that do not rise to the level of being material but are important enough to merit attention by those responsible for oversight of the entity’s financial reporting.

Each DoD component that is considering the use of the Purchases Method under the significant amount exception should perform the below test at its entity’s consolidated statement level. For example, the Department of the Navy would perform the test steps based on the Navy Financial Statements not at an individual Navy command level.

The DoD component must perform these steps in the sequence in which they are listed. For purposes of calculating the amounts in the steps below, the DoD component should use the most recent fiscal year annual amounts from its general ledgers or trial balance and corresponding annual financial statements. Any DoD component that will not undergo a standalone audit or examination and is not part of a larger component’s standalone audit or examination can perform this analysis against the consolidated DoD General Fund or Defense Working Capital Fund financial statements as applicable. If the DoD component does not have access to the financial information necessary to perform the tests, the significant amounts exception cannot be used.

Step 1: Determine the aggregate value of the OM&S categories for which the Purchases Method is being considered or is already used. General Fund and Working Capital Fund balances should be analyzed separately. A combination of general ledger balances,

acquisition data, and expense data may be used to determine the aggregate value of the OM&S under consideration.

Step 2: Compare the aggregate value of the OM&S under consideration to 1% of the component's Gross Cost.

- A. Multiply the "Gross Cost" amount from the component's Statement of Net Cost by 1%.
- B. If the aggregate value of the OM&S being analyzed is greater than or equal to 1% of Gross Cost, the amount is significant and the significant amount exception cannot be used to justify the use of the Purchases Method for the OM&S under consideration.
- C. If the aggregate value of the OM&S is less than 1% of Gross Cost, proceed to Step 3.

Step 3: Compare the aggregate value of the OM&S under consideration to 1% of Total Assets.

- A. Multiply the "Total Assets" amount from the component's Balance Sheet by 1%.
- B. If the aggregate value of the OM&S being analyzed is greater than or equal to 1% of Total Assets, the amount is significant; the significant amount exception cannot be used to justify the use of the Purchases Method for the OM&S under consideration.
- C. If the aggregate value of the OM&S is less than 1% of Total Assets proceed to Step 4.

Step 4: Compare the aggregate value of the OM&S under consideration to 3% of the lesser of the Inventory & Related Property (I&RP) line of the Balance Sheet or the Operations, Readiness, and Support (OR&S) line of the Statement of Net Cost.

- A. Select a base for performing Step 4. The suggested base is the lesser of the I&RP line of the Balance Sheet or the OR&S line of the Statement of Net Cost.
- B. Multiply the selected base by 3%.
- C. If the aggregate value of the OM&S being analyzed is greater than or equal to 3% of the selected base, the amount is significant and the significant amount exception cannot be used to justify the use of the Purchases Method for the OM&S under consideration.
- D. If the aggregate value of the OM&S is less than 3% of the selected base, the amount is not significant and the significant amount exception can be used to justify the usage of the Purchases Method of expense recognition for the OM&S under consideration.

Components using the Purchases Method based on the significant amount exception should re-perform and document the above tests at least annually.

Criterion 2: *The OM&S are in the hands of the end user for use in normal operations*

“End User” and “Normal Operations” are key terms used within Criterion 2. Each term is discussed in further detail below:

End User

SFFAS No 3, paragraph 41, defines an end user as “any component of a reporting entity that obtains goods for direct use in the component’s normal operations. Any component of a reporting entity, including contractors, that maintains or stocks OM&S for future issuance shall not be considered an end user.” To help further define an end user, DoD supply chain procedures and activities were analyzed, and in particular DoDM 4140.01, “DoD Supply Chain Materiel Management Procedures,” Volume 2, which outlines three categories of supply locations within the supply chain. The supply point categories are as follows:

1. **Wholesale** – These supply points are the highest level of organized DoD supply and conduct typical wholesale operations such as bulk receipt, repairs, and storage of OM&S. Wholesale locations maintain stocks to resupply retail supply points and to issue to the field, meaning the OM&S is held for future issuance. Depots, contractor controlled depots, warehouses, and storage facilities are examples of wholesale sites.

Wholesale locations are not considered end users, except for OM&S that is held and managed for consumption within the wholesale activity itself.

2. **Retail** – These supply points stock inventory below the wholesale level, either at the consumer level (directly supporting customers) or at the intermediate level (supporting a geographical area).

Retail locations are not considered end users, except for OM&S that is held and managed for consumption within the retail activity itself.

3. **Field** – Receiving organizations that are authorized to use supply items and only requisition quantities sufficient to satisfy their own immediate requirements. Receiving organizations do not reissue OM&S to other organizations but use or consume OM&S within their normal operations. Examples of field supply points include but are not limited to ships (e.g., shipboard storage), submarines, aircraft wings, field units and missile wings.

Any OM&S at a field supply point can be considered to be in the hands of the end user. This does not include prepositioned stocks which can be stored in remote and field locations but are held for future issue.

Each DoD component may define their supply structure differently than what is described above. However, the principles will still apply. When using the end user criterion to apply the Purchases Method or determine when OM&S can be expensed, DoD components should map their supply point structures and activities to the above categories to determine whether they meet the end user definition.

Additionally, government material furnished to contractors will only be considered in the hands of an end user if the contractor is consuming the material in the course of its normal operations on behalf of the government. If the material is stored in anticipation of being incorporated into an end item, it is not OM&S and should be accounted for in Construction-in-Progress or Work-in-Process accounts. If the material is held for further issuance, the contractor location is the equivalent of a wholesale or retail location, and as a result, cannot be considered an end user.

Normal Operations

SFFAS 3 does not provide guidance on what is considered normal operations. Title 41, Public Contracts and Property Management, of the Code of Federal Regulations section 101-8.705 defines normal operation as the, “operation of a program or activity without significant changes that would inhibit meeting objectives.”

OM&S used in normal operations are goods necessary for DoD components to meet their objectives. Evidence that OM&S is used in normal operations can be, but are not limited to OM&S required on a recurring basis, high inventory turnover rates, or significant purchase activity. Examples of ways to demonstrate and document this evidence can be through the performance of a consumption analysis or the documented procedures used to develop supply and mission readiness lists (e.g., Coordinated Shipboard Allowance List (COSAL), Aviation Consolidated Allowance List (AVCAL), etc.).

Criterion 2 Summary

Other indications that OM&S is in the hands of the end user for use in normal operations are that the activity or location:

- Only requisitions quantities sufficient to satisfy its own immediate requirements (includes regular supply levels plus emergency/safety stock);
- Does not requisition large quantities of OM&S to issue to other organizations outside of their own;
- Is not a forwarding agent. The OM&S is requisitioned for the intent of use, not to resupply other supply points;
- Has the right to consume the OM&S; and
- Is permitted to carry only certain levels of OM&S.

Criterion 3: *It is not cost-beneficial to apply the Consumption Method*

Paragraph 40 of SFFAS 3 permits the use of the Purchases Method if it is not cost-beneficial to apply the Consumption Method of accounting. The standard does not provide guidance on analyzing the cost-benefit of applying the Consumption Method.

Each DoD component considering using the cost-beneficial exception should conduct an analysis comparing estimated costs and benefits for applying the Consumption Method. If costs exceed benefits, then the Purchases Method may be used. A cost benefit analysis should be unbiased, fully documented (e.g., outline of procedures performed, supporting documents for cost estimates, etc.), reviewed, and approved by the component’s management. Non-monetary cost and benefits may also be analyzed using a multi-criteria decision analysis technique. See Appendix A for an example of how a cost benefit analysis may be structured.

Appendix A: Cost Benefit Template Example

Costs	Source/ Support Examples	\$	Additional Benefits Beyond Current Process/System	Source/ Support Examples	\$
System/Technology Costs <ul style="list-style-type: none"> • Locations/instances that need to be purchased and installed • Interfaces that need to be built • Near-term sunset of current systems and implementation of new systems • Additional bandwidth or connectivity requirements • Additional hardware requirements 	<ul style="list-style-type: none"> • Vendor quotes or Cost Estimates • Make or Buy analysis 		Management <ul style="list-style-type: none"> • More comprehensive enterprise view of location, status of OM&S • Reduction in effort for OM&S returning to supply chain • Purchasing decisions • Better financial stewardship and oversight of OM&S balances 	<ul style="list-style-type: none"> • Duplicative / unnecessary purchases • Return to warehouse transaction totals 	
Human Capital Costs <ul style="list-style-type: none"> • Additional training required at field locations • Additional FTEs / Contractors 	<ul style="list-style-type: none"> • Vendor Quotes or Cost Estimates • Capacity Models 		Users of the Financial Statements <ul style="list-style-type: none"> • Fuller picture of true OM&S and asset balances 	<ul style="list-style-type: none"> • Organizational survey • Accounting interviews • Logistics interviews 	
Process Costs <ul style="list-style-type: none"> • Contract modifications (for Government Furnished Materials) • Process re-engineering, including internal controls and timely financial reporting 	<ul style="list-style-type: none"> • Estimated Contract Cost • Vendor quotes or cost estimates • Project Cost estimates 		Process Benefits <ul style="list-style-type: none"> • Improved business processes and internal controls 	<ul style="list-style-type: none"> • Trend Analysis 	
Total			Total		