Department of Defense
Office of the Under Secretary (Comptroller) (OUSD(C))
Expense Recognition of Operating Materials and Supplies

Purpose

The purpose of this paper is to determine the timing of expense recognition of Operating Materials and Supplies (OM&S) items based upon guidance set forth in Statement of Federal Financial Accounting Standards (SFFAS) No. 3 *Accounting for Inventory and Related Property*. The complexity associated with the execution of the Department of the Defense's (the Department's) mission and weaknesses in IT systems, contribute to the Department's challenge of determining the timing of expense recognition for OM&S items.

SFFAS No. 3, paragraph 36, defines OM&S as tangible personal property to be consumed in normal operations. In addition, SFFAS No.3, paragraph 38 and 40, permits two methods for expense recognition. Generally, OM&S items should be recognized and reported as assets when produced or purchased, because SFFAS No. 3 recommends Federal agencies implement the consumption method of accounting for OM&S.

While the consumption method of accounting is recommended, SFFAS No. 3, paragraph 40, permits the use of the purchase method of accounting, allowing for expense recognition at the time of purchase, if one of the following conditions related to OM&S items is present:

- The amount of the type of OM&S item is not significant to the Federal agency,
- The OM&S items are in the hands of the end user for use in normal operations, or
- It is not cost-beneficial to apply the consumption method of accounting.

This paper focuses on expense recognition for OM&S items under the consumption method. Furthermore, the following OM&S topics are outside the scope of this paper:

- Valuation of OM&S items,
- System limitations inhibiting implementation of SFFAS No. 3,
- Accounting for constructed OM&S items,
- Inventory and Related Property items not considered to be OM&S, and
- Conformity with Office of Management and Budget Circular A-136 *Financial Reporting Requirements*.

Background

As of September 30, 2012, the Department reported $243B in Inventory and Related Property, which included $153B of OM&S items. The remaining Inventory and Related Property is comprised of spare and repair parts, clothing and textiles, and fuels held for sale as Inventory by the Defense Working Capital Funds.

The following table details the Department's OM&S items as of September 30, 2012 for each of the major Components:

Operating Materials and Supplies, Net					
	Army-GF	**Air Force-GF**	**Navy- GF**	**Other DoD**	**Total**
As of September 30, 2012	$31B	$49B	$68B	$5.B	$153B

The above balances include OM&S items, such as:

- Spare and repair parts,
- Ammunition,
- Tactical missiles,
- Aircraft configuration pods, and
- Centrally managed aircraft engines.

As noted above, SFFAS No. 3, paragraph 38, generally recommends Federal agencies use the consumption method in accounting for OM&S items. However, due to automated system limitations, the Department uses both the consumption method and the purchase method of accounting. OM&S items that are centrally managed and stored, such as ammunition and engines, are generally recorded using the consumption method and are reported on the Balance Sheet as OM&S. However, the Department also expenses significant amounts of OM&S using the purchase method because current systems do not support the consumption method or management deemed that the items were in the hands of the end user.

Implication of the matter

Difficulties in defining an end user, normal operations, and consumption of OM&S items for purposes of conformity to SFFAS No. 3, and the timing of expense recognition, have several implications to the Department and its Components' ability to produce auditable financial statements. Specifically, non-conformity with SFFAS No. 3 may result in a material departure from generally accepted accounting principles (GAAP) in the United States of America. Non-conformity with SFFAS No. 3 may also lead to material misstatements in the financial statements due to the timing of expense recognition by overstating/understating the Inventory and Related Property line item on the Balance Sheet and Gross Costs on the Statement of Net Cost, respectively.

Actions taken to address the matter

In order to identify the requirements necessary for GAAP conformance, one must review criteria in sequence within the hierarchy of Federal GAAP, as defined in Statement of Auditing Standards (SAS) No. 91. The hierarchy lists the priority sequence of sources that an entity should follow under accounting and reporting guidance. The American Institute of Certified Public Accountants (AICPA) defines the Federal GAAP hierarchy as the following:

- Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations, as well as AICPA and Financial Accounting Standards Board (FASB) pronouncements specifically made applicable to Federal governmental entities by FASAB Statements or Interpretations
- FASAB Technical Bulletins and, if specifically made applicable to Federal governmental entities by the AICPA and cleared by the FASAB, AICPA Industry Audit and Accounting Guides and AICPA Statements of Position
- AICPA Practice Bulletins, if specifically made applicable to Federal governmental entities and cleared by the FASAB, as well as Technical Releases of the Accounting and Auditing Policy Committee of the FASAB
- Implementation guides published by the FASAB staff, as well as practices that are widely recognized and prevalent in the Federal government.

Consistent with the above, SFFAS No. 3 is the relevant criteria that set forth the accounting requirements related to OM&S items. Accordingly, SFFAS No. 3 was reviewed to understand the requirements related to accounting for OM&S items, as they relate to the end users, normal operations, consumption, and expense recognition.

The Department of Defense, Financial Management Regulation (DoD FMR), Volume 4, Chapter 4, and Volume 6B, Chapter 10 was also reviewed to determine the consistency between internal policy guidance and the accounting requirements.

Evidence obtained to support point of view

Review of SFFAS No. 3

Based on review of SFFAS No. 3, the following was noted regarding the accounting methods for expense recognition, the end users and consumption in normal operations.

Consumption method of accounting

SFFAS No. 3, paragraph 39 notes that the cost of goods shall be removed from OM&S (i.e. the asset account) and reported as an operating expense in the period they are issued to an end user for consumption in normal operations.

Based upon the above, the guidance requires Federal agencies to determine the following to ensure appropriate timing of expense recognition:

- End user of the OM&S items and
- Consumption of OM&S items in normal operations.

End user of the OM&S items

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 maintain or stock operating materials and supplies for future issuance are not considered an end user.

Based upon the above, end users are the individuals and/or units (e.g. flight operations.) that are the intended consumers of the type of OM&S items. Due to the nature of the Department's OM&S items, multiple end users may exist and the end user may vary due to the nature of the OM&S items. Furthermore, the OM&S items must be issued to the end user for the purpose of consumption/direct use.

Consumption in normal operations

The term normal operations refers to the intended use of the OM&S item, which may vary depending upon the nature of the OM&S item, its intended use, and the nature of the Federal agency's day-to-day operations. Federal agencies should consider the probability of consumption/actual use of the OM&S item when issued to the end user for normal operations - - there could be situations where the OM&S item is issued to the end user, but it is not probable that the OM&S item will be consumed in the period of issuance.

The term consumption indicates that the OM&S items are issued to the end user for direct use in normal operations. Pre-positioning or future re-issuance of the OM&S item, without certainty of actual use/consumption, is not considered consumption.

Accordingly, expense recognition for OM&S items should occur when the OM&S items are issued to the end user for consumption in normal operations.

<u>Purchase method of accounting</u>

As noted in the *Purpose* section of this paper, SFFAS No. 3, paragraph 40, permits the use of the purchase method of accounting, if one of the following conditions related to OM&S items is present:

- The amount is not significant to the Federal agency,
- The OM&S item is in the hands of the end user for use in normal operations, or
- It is not cost-beneficial to apply the consumption method of accounting.

Amounts not significant to the Federal agency

The FASAB does not define the term materiality to the accounting community. Instead, the Board notes that it is a matter of judgment on the part of the preparer of the financial statements. FASB Statement of Financial Concepts No. 2, *Qualitative Characteristics of Accounting Information* defines materiality as the magnitude of an omission or misstatement of an item in a financial report that, in 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 items.

Therefore, Federal agencies should use their judgment to determine types of OM&S items that are insignificant.

OM&S items in the hands of end Users

Federal agencies should determine whether the purchased OM&S items are provided directly, for use, to the end users. In those cases, the use of the purchase method is appropriate.

Not cost-beneficial

Federal agencies should consider the cost of tracking a type of OM&S item under the consumption method of accounting relative to the benefits of having that information. If the Federal agency determines that the cost outweigh the benefits of using the consumption method, the Federal agency may use the purchase method of accounting for that type OM&S item.

<u>*Review of DoD FMR*</u>

The DoD FMR was reviewed to obtain an understanding of the requirements related to accounting for OM&S and the conformity of the Department's current policy to the guidance in SFFAS No. 3. The DoD FMR, Vol. 4, Chapter 4, Sub 0402, which is the financial management policy and regulation for OM&S, is consistent with the requirements set forth in SFFAS No. 3.

Review of other Federal financial statements and reports

Due to unique nature of the Department's OM&S items (e.g. tactical missiles); other Federal agencies that have similar issues related to the accounting methods and the timing of expense recognition of OM&S items were not identified.

Instead, reports issued by the Government Accountability Office (GAO) were identified, which addressed the Department's challenges to ensure consistent accounting for OM&S.

A GAO Report (GAO/AIMD-98-16) noted that combat ships frequently hold materials in storerooms until the work center requisitions items for repair work or other uses. Furthermore, Navy supply officers store OM&S items at shore locations for subsequent issuance to aircraft carriers and submarines. These items were not reported as OM&S on the Balance Sheet, which may be an indication that the expense recognition may occur prior to issuance to the end users.

Another report issued by the GAO (GAO-09-147R) noted that the Department routinely prepositions materials and equipment at strategic locations around the world in order to field combat-ready forces in days rather than weeks. While this is practical and necessary for combat preparedness, it is likely that the expense recognition occurs when items are issued from supply depots to the strategic locations, resulting in expense recognition prior to the issuance of the OM&S items to the end users.

Final conclusion reached and basis thereof

As noted above, the Department's existing policy guidance is consistent with the requirements set forth in SFFAS No. 3. However, due to the complexity and uniqueness of the Department's environment, implementation guidance may be necessary to ensure consistent application of the policy. Based upon requirements set forth in SFFAS No. 3, the Department should, depending upon the situation, use either the consumption method of accounting or the purchase method of accounting. Below are recommended procedures the Components could use to ensure consistent expense recognition under both accounting methods.

Consumption method of accounting

Consistent application of the consumption method of accounting is contingent upon the Department's ability to identify the intended end user, normal operations and consumption/direct use of OM&S items. Due to the multi-purpose nature of OM&S items and various potential end users, the Department struggles to identify the appropriate timing of expense recognition. It is recommended that the Department develop supplemental guidance to ensure the appropriate timing of expense recognition and the consistent application of the consumption method of accounting. The guidance should detail specific OM&S types (e.g. tactical missiles), intended end users, normal operations and examples of consumption/direct use.

Based on the above, the Department should perform the following procedures, for each type of OM&S items, to determine the timing of expense recognition:

1. Identify each type of OM&S items, which may currently be purchased using both accounting methods,
2. Identify the amount of OM&S items purchased, issued, returned, consumed and on-hand at year-end for several fiscal years,
3. Perform analysis detailing the inventory turnover and trends to determine the rate of issuance, consumption, and returns of the OM&S items,
4. Determine the cost-benefits of tracking the OM&S items until consumed, and
5. Categorize each type of OM&S items as the following:

    - Consumption in the period of issuance is probable (e.g. 95% of issued items are consumed),
    - Consumption in the period of issuance is not probable and it is cost-effective to track the OM&S items until consumed, or
    - Consumption in the period of issuance is not probable and it is not cost-effective to track the OM&S items until consumed.

The following risks should be considered related to the above analysis:

- Data used for the analysis may be incomplete (e.g., direct purchase OM&S items may not be included),
- Data used for the analysis may be inaccurate (e.g., year-end balance may not be correct due to errors in physical inventory), and
- The time-period covered in the analysis might not depict normal operation for the OM&S items (e.g. excessive use due to abnormal operational requirements).

Use the results of the above analysis and review Appendix A *Timing of expense recognition*, to determine the timing of expense recognition.

Purchase method of accounting

While the consumption method of accounting is preferred, it may not be cost beneficial to apply this method for certain types of OM&S items (e.g. low cost spare & repair parts), the type of OM&S item may not be significant to the Department, or the OM&S items may be in the hands of the end users. In these situations, the Department may use the purchase method of accounting. The Department should identify specific OM&S types for which the purchase method of accounting is appropriate and integrate these positions with the guidance for implementation of the consumption method of accounting.

Criteria for selecting accounting method and the timing of expense recognition

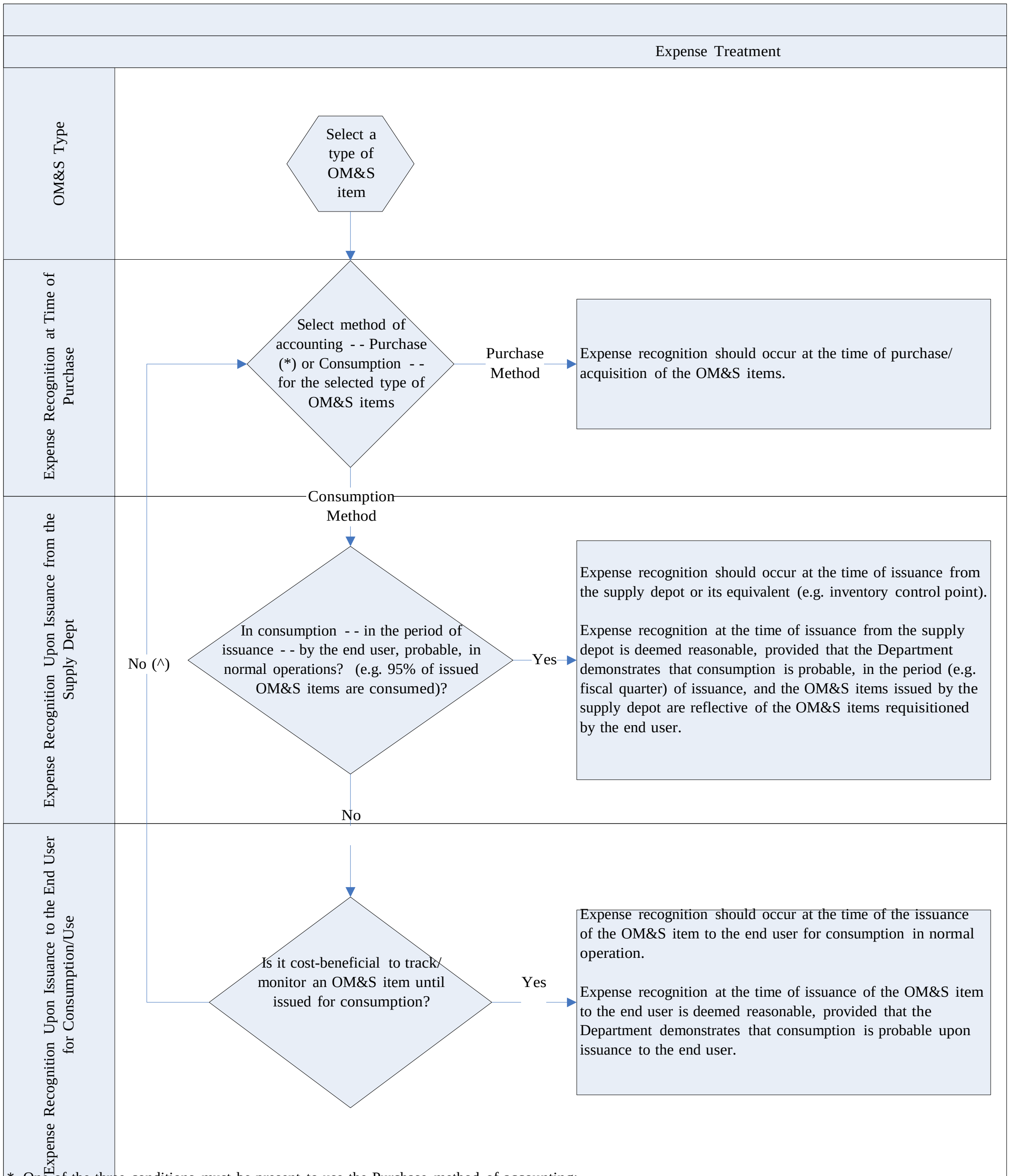
The Department should review the chart in Appendix A *Timing of expense recognition*, which details the steps to be considered to determine the accounting method and the timing of expense recognition.

Documentation

The Department and the Components should document the following to detail its basis for the accounting method and the timing of expense recognition:

- The relevant risks and factors;
- The analysis performed, including validity of the data (e.g. completeness, accuracy);
- The results of the analysis; and
- The selected accounting method and the timing of expense recognition.

Appendix A: Timing of expense recognition



* One of the three conditions must be present to use the Purchase method of accounting:

1- The amount is not significant to the Federal agency,
2- The OM&S items are in the hands of the end users for use in normal operations, or
3- It is not cost-beneficial to apply the consumption method of accounting.

^ Reconsider the use of the Consumption method of accounting.