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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON ECONOMY IN THE GOVERNMENT
JOINT ECONOMIC COMMITTEE
ON
ECONOMY IN GOVERNMENT

Mr. Chairman and Members of the Committee:

I am pleased to appear before this Subcommittee today to elaborate on certain matters covered in my statement of November 27, 1967. My statement will cover the following areas:

1. Inventory Management.
2. Agency Audit Rights and Recovery from Subcontractors.
3. Government Property in Possession of Defense Contractors.

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INVENTORY MANAGEMENT

The primary objective of inventory management in the military departments is to provide adequate materiel support to their organizations and to avoid the accumulation of excesses. If this objective is to be attained, no more money should be invested in inventories than is necessary for effective support. Therefore, accurate and current records of quantities of specific items in the inventory must be available for use in determining whether user requisitions can be satisfied and whether, on the basis of requirements computations, procurement actions are necessary. This entails controlling and accounting for the massive volume of transactions which daily affect the status of the over 4 million items in the inventory.

As a part of inventory control and accounting, the Department of Defense has directed that all items held in stock be physically inventoried not less than once each year either by full count or by statistical sampling techniques; however, exceptions are permitted for slow-moving items and other items, provided that storage conditions and lack of movement ensure adequate physical protection and accuracy of records. Also, the Department of Defense has directed that inventory records and reports be reconciled promptly on the basis of physical inventories.

Each of the three military departments and the Defense Supply Agency has published policies and procedures which implement the Department of Defense policy. In addition, the procedures of the

military departments provide for special physical inventories which are one-time unscheduled physical counts of one or more line items (1) when the stock record shows a balance on hand but the warehouse indicates no stock physically available to fill a request for the material, (2) to correct a suspected discrepancy between the recorded stock record balance and the assets on hand, and (3) on request from the inventory manager or another appropriate official. These special inventories are recognized by all the supply components of the Department of Defense to be emergency measures which are not meant to substitute for the scheduled physical inventory program.

Last May, before this Subcommittee, we expressed some concern over the need for substantial improvements in inventory control within the Department of Defense. The inaccuracy of inventory records, and the consequent adverse effect on the efficiency and economy of inventory management within the Department of Defense has been the subject in the past of a number of reports by the General Accounting Office. The internal audit organizations within each of the military services have also consistently pointed out a number of serious defects in this area. The problem area continues to be one which, in our opinion, needs considerable attention.

Inventories in the Department of Defense are valued at about \$37 billion, excluding aircraft, ships, and supplies and equipment in the hands of using units. On November 14th of this year, we issued a report to the Congress on the results of our review of inventory controls over

that portion of this inventory which is held in depots in the United States. These inventories totaled \$10.4 billion in spare parts, components and supplies, exclusive of ammunition and vehicles.

We found in our review that significant differences existed between stock record balances and the actual quantities of items in depot inventories throughout the supply systems. This was evidenced by frequent and voluminous adjustments being made to the stock records by the services. We found that the inventory records were adjusted up or down, that is, gross adjustment, an average of \$2.4 billion annually in fiscal years 1965 and 1966.

Factors which we feel contributed to the significant amount of inventory adjustments were (1) inaccurate stock locator cards; (2) physical inventories frequently made without proper control of documentation for receipts and issues occurring during the period of the inventory; (3) lack of proper reconciliations between the physical inventory counts and the stock records at the completion of these inventories and determinations as to the causes of the imbalances; and (4) failure of supply personnel to follow inventory control procedures.

Following are examples of some of the conditions noted in our review and included in our report. A draft of this report was submitted to the Department of Defense for comments prior to its issuance to the Congress. These examples, we believe, demonstrate the extent and significance of inventory control problems and the impact that loss of inventory control has on the functioning of the military supply systems.

Significant differences between stock records and actual inventories

1. The Navy Supply Center, Norfolk, had an average inventory of \$442 million. Approximately 61 percent of the records for the 239,000 items physically inventoried during fiscal year 1965 and 1966 contained significant errors requiring gross inventory adjustments totaling \$33 million.

2. As a result of special physical inventories taken in fiscal year 1966, the Oklahoma City Air Materiel Area found it had over \$37 million worth of assets in store which were not reflected on either the stock records or the locator records.

Errors in stock locator records

1. A system-wide error rate of about 13 percent was found to exist in Navy stock locator records as a result of location audits performed at 23 Navy stock points during fiscal years 1965 and 1966. The location audits revealed that 778,000 of the 6 million audited stock locations were discrepant. The discrepancies included (1) materiel in storage but now shown on stock locator records and (2) actual storage location did not agree with recorded storage location.

2. An analysis of 3,475 materiel release denials processed by the Sharpe and Red River Army depots during a 3-month period ending September 1966 disclosed that 1,232, or about 35 percent, of the denials were caused by a mislocation of stored stocks.

3. We found that the Navy Supply Centers, Norfolk and Oakland, did not have effective controls over receipts to insure that materiel was properly stored and entered on the records within the prescribed 5-day period. At Norfolk, we tested the receipt processing time required for 54 receipts of materiel which were logged in at a central receiving warehouse during the period February 1966 to July 1966. We found that the processing time required for 38, or 70 percent, of these receipts ranged from 6 to 72 days. We also found that three materiel receipts, valued at about \$34,000, had been in storage for varying periods up to 200 days but had not been entered on the records.

Excessively large number of special inventories

As a result of the extensive differences between stock records and actual inventories, DOD supply activities resort to a large number of special inventories to resolve the differences and to locate missing stocks. For example,

1. The data furnished to us by the Army Materiel Command indicate that its depots, which are responsible for 514,000 line items of depot stocks, conducted over 900,000 special inventories between January 1965 and June 1966. From this it appeared that, in addition to regularly scheduled physical inventories, it was necessary to count each item an average of 1.7 times during the 18-month period. However, some items were counted many times. For example, one depot conducted, within a 30-day period, five or more special inventories for each of 92 items.

2. For fiscal year 1966, the Air Force Logistics Command indicated that its five active Air Materiel Areas (AMA) had conducted special inventories of 277,254 line items. This number of special inventories are equal to about 30 percent of the total items in their inventories.

3. At the two Navy supply centers included in our review, we found that, in fiscal years 1965 and 1966, approximately 90 percent of the inventory effort was concentrated on special inventories.

In our opinion, the widespread use of special inventories in lieu of improved inventory control practices is costly and ineffective. The extensive workload associated with taking these special inventories frequently restricts the taking of systematically scheduled physical inventories.

Inadequate investigation of discrepancies

We noted instances in which a series of offsetting adjustments to the records on individual items of supply were made without adequate investigation to determine the reasons for the discrepancies. For example:

1. At one Defense Supply Agency center we noted a series of six adjustments made in about a one-year period to the records for water chlorination kits. These six adjustments ranged from a minus adjustment of 9,404 units to a plus adjustment of 11,829 units. The result of this series of adjustments was a net increase to the records of 1,225 units. Personnel of the center concluded that no further investigation or corrective action was necessary on this item inasmuch as the series of adjustments appeared to be offsetting.

2. As a result of physical inventories taken in four Army depots during 1966, inventory adjustments totaling about \$197 million were made to the stock records without research and reconciliation of major stock variances. Our tests of some of these adjustments showed that the adjustments were in error. If reconciliations had been made of the discrepancies, it would have become clear that the differences could have been accounted for by transactions in process.

Prescribed physical inventories not taken

1. Overall data for the period February 1965 to June 1966 submitted for the 20 Army depots show that none of the depots performed the number of regularly scheduled physical inventories or location audits required by Army regulations. In many instances, complete counts of items were omitted and, in some instances, required sample inventories were omitted. Furthermore, five of the depots performed no location record audits. The reasons given for these failures to conduct scheduled physical inventories were (1) utilization of personnel resources for special inventories, (2) conversion to new or revised major logistical systems, and (3) the workload caused by the Southeast Asia buildup.

2. The two Navy locations included in our review were required to perform scheduled inventories annually on approximately 920,000 line items in fiscal years 1965 and 1966. However, during these fiscal years, less than 6 percent of the scheduled inventories were taken. Special inventories accounted for 90 percent of the inventory effort.

3. Available data showed that Defense Supply Agency activities had about 1.9 million active line items on hand. During fiscal years 1965 and 1966, approximately 40 and 9 percent, respectively, of the DSA active items were physically inventoried by complete or statistical sampling methods. In addition, the data indicated that the DSA supply activities made less than 50 percent of the required location audits.

DSA officials indicated that one of the reasons for the substantial decrease from 1965 to 1966 in the number of line items physically inventoried was the workload associated with increased support to Southeast Asia. They indicated also that the failure to make the majority of the location audits was due in large part to a new depot warehousing and shipping system.

At the conclusion of our review, we brought our findings to the attention of the Secretary of Defense along with our proposal that the military departments and the Defense Supply Agency be directed to take the necessary steps to attain an acceptable degree of stock record accuracy for depot inventories.

We proposed further that the Secretary of Defense establish a group, composed of representatives from the military departments and the Defense Supply Agency, to study the problems of inventory control in depth with an objective of resolving the broad basic causes for these problems and to make recommendations that will correct the conditions uniformly throughout the Department of Defense.

The Department of Defense, in commenting on our draft report, in July 1967, concurred, in general, with our findings.

We were advised that each of the military services and DSA had initiated specific programs to eliminate the types of inventory control problems discussed in our report and each was in the process of installing new procedures which were aimed at more accurate inventory control. We were advised that the installation of the new procedures had advanced to the point where fruitful results could be anticipated within a relatively short period of time. We were told that the need for establishment of a special inventory study group would be reconsidered and, if necessary, organized after an evaluation of the results was obtained from the new procedures.

In testimony before this Subcommittee on November 28, 1967, the Defense representatives testified that the material included in our report dealt with discrepancies that show up in a 4 million item inventory. The Defense representatives went on to say that the net difference between gains and losses in dollars was only 1 percent in 1965 and 1.4 percent in 1966 and that the largest merchandising houses consider 2 percent net adjustment to be quite satisfactory.

We recognize that in private industry a net adjustment figure (gains offset by losses) can be used to measure the extent to which profit or loss has been affected during a particular accounting period or the extent to which capital investment in inventories has been affected by inventory adjustments. However, this figure does not give a satisfactory indication of the effectiveness of inventory controls or the reliability of the inventory records. For these purposes, gross adjustments (the total of gains and losses) is a more meaningful figure.

An excessive volume of gross inventory adjustments is a clear indication that, in a large number of instances, the inventory accounts for specific items were inaccurate in relation to actual stocks on hand and, therefore, represented potential management problems. In those cases where records indicate more stock on hand than actually exists, there is a distinct danger that when stocks are depleted, orders cannot be filled. On the other hand, when the inventory records do not reflect all of the stock that is actually available, unnecessary procurements may be made and potential excesses generated. Since either of

these conditions represent an unsatisfactory condition requiring management attention, it seems more appropriate that gross inventory adjustments be used as a measure of the effectiveness of the stock control practices and records.

Since the purpose of maintaining inventory records is to have accurate information available as to the quantities and location of stock on hand, an excessively high ratio of gross adjustments to average inventory is a strong indication that such inventory records are not accomplishing the purpose for which they are maintained and that necessary controls over the inventories are absent or inadequate.

Conclusions and Additional Actions Required

We believe that the increased emphasis which DOD has stated that the military services and DSA are placing on more positive enforcement of the existing policies and procedures for control of depot inventories should, if effectively pursued on a continuing basis, result in greater stock record accuracy and increased supply effectiveness.

However, on the basis of other studies we have made of inventory controls and supply system responsiveness, we believe that there are certain broad basic factors which have a significant bearing on the effectiveness of inventory controls in the Department of Defense.

For example, we believe that the organizational structure of the supply systems in some cases may contribute substantially to the difficulties encountered in control of inventories. The responsibility for physical receipt, storage, and issue of stocks of the same item is frequently decentralized to several storage activities. The management

and accounting responsibility for these same stocks is centralized at another supply activity which has no direct authority or control over the practices of the storage activities. Thus, it is difficult to establish responsibility for errors or loss of control because no single organization has the direct authority, responsibility, or perhaps motivation to reconcile differences and ensure closer control.

Another important factor which we believe warrants considerable attention is the need for increased supply discipline throughout the supply systems. This is essential if the accuracy and completeness of inventory records and related supply management data is to be improved. Frequently, we find that the services have devised adequate system and procedures, but the people upon whose actions the operation of the systems depends do not always do that which is required and when it is required. To the extent that people at all levels of the supply system are motivated to follow prescribed procedures and maintain a high degree of accuracy in their work, more accurate and complete management data and information will result.

We do not believe at this time that there is any need for specific legislation in connection with improvement of inventory controls. The basic responsibilities and authorities have been established. Rather, we believe that creative thinking needs to be applied to basic problems and causes such as organizational structure and supply discipline cited above. It is to deal with basic factors such as these that we suggested a special study group within the Department of Defense should be established.

We believe the interest and concern with inventory controls evidenced by this Subcommittee, as well as others in the Congress, is especially important in assuring that a high degree of management attention is focused on this problem. In other words, we believe the Congress and its Committees can be a strong motivating factor to the departments to further their efforts in developing solutions.

For the immediate future, we intend to concentrate our efforts on study of the organizational structures, alignment of responsibilities and authority, and numbers and types of personnel involved in inventory management. We also intend to examine more closely the policies, procedures, and practices used by the military services and DSA relative to the receipt and storage of material, and the processing of related transaction documents affecting the inventory records. In connection with this work, we intend to consider the organizational structure and methods used in commercial enterprises to determine if there are any techniques that may have application to the solution of inventory control problems in the Department of Defense.

AGENCY AUDIT RIGHTS AND RECOVERY FROM SUBCONTRACTORS

Agency Audit Rights

About two years ago we recommended to the Secretary of Defense that a provision be included in all contracts, required to be negotiated on the basis of cost or pricing data, giving agency officials the right to examine all records related to the contract performance. This recommendation was made to provide agency officials a more effective means of implementing the "Truth in Negotiations Act," P.L. 87-653.

We had found that significant cost information was often not disclosed to Government negotiators at the time of price negotiations. Such undisclosed information could be more readily detected in post-award reviews of the contract performance records. Although an examination of such records provided the best means of verifying that the data submitted before negotiations was accurate, current and complete, agency officials did not have the right to do so under negotiated firm fixed-price contracts and subcontracts.

This matter was discussed in hearings before your Committee in May 1967.

In June 1967, both you and Congressman Minshall introduced bills to provide agency representatives the right to examine all data related to the negotiation, pricing or performance of contracts and subcontracts where cost or pricing data are required.

In commenting on the proposed legislation in July 1967, we stated that we were in favor of its passage.

Thereafter, in September 1967, the Deputy Secretary of Defense directed that action shall be taken to include in all noncompetitive firm fixed-price contracts a contractual right of access to the contractor's actual performance records. The directive was silent on the agency's right of access to the subcontractor's records. We advised Defense officials of this apparent omission, and we were advised that this matter would be considered in drafting the regulations. The Armed Services Procurement Regulation was revised November 30, 1967, effective as soon as received, to provide for an appropriate clause to be included in all contracts and subcontracts, where cost or pricing data are required. (Pertinent excerpts from the regulation are attached.)

We believe the revised regulations will accomplish by administrative action what would be required by enactment of the legislation. We recognize that regulations are more easily changed or rescinded than an act of Congress and are perhaps more susceptible to misinterpretation or oversight. While we have no reason to anticipate, in this case, that the regulations will be either later rescinded or not followed, we would, of course, have no objection if the Congress should decide to enact this provision into law. We intend to observe closely the contracting agencies' practices with regard to the regulations.

Recovery from Subcontractors

Under the existing provisions of the ASPR, the Government's right to reduce the contract price extends to cases where the prime contract

price was increased because a subcontractor furnished defective cost or pricing data. Problems have arisen with respect to the Government's right to a price adjustment where the subcontractor has submitted defective data after the prime contract price has been established. These problems are being studied by the Department of Defense and by our office. (Pertinent excerpts from the regulation are attached.)

GOVERNMENT PROPERTY IN THE
POSSESSION OF DEFENSE CONTRACTORS

It is the policy of the Department of Defense that contractors will furnish all facilities required for the performance of Government contracts, except that facilities may be provided by the Government when (1) contractors are either unwilling or unable to do so and no alternate means of obtaining contract performance is practical or (2) furnishing existing Government-owned facilities is likely to result in substantially lower cost to the Government of the items produced, when all costs involved--such as costs of transporting, installing, maintaining, and reactivating such facilities--are compared with the cost to the Government of the contractor's use of privately owned facilities. Also, it is the policy of the Department of Defense to have its contractors maintain the official records of Government-owned property in their possession.

The Government's inventory of property in the hands of contractors consists of property which the Government has furnished and property procured or otherwise provided by contractors for the account of the Government. Basic policies governing the control of this property are set forth in the Armed Services Procurement Regulation.

At your Subcommittee hearings on November 28, 1967, representatives of the Department of Defense indicated that the total value of Government-owned property in the possession of contractors amounted to about \$14.9 billion. This figure includes an estimate of \$3 billion, representing the value of special tooling and special test equipment held by contractors.

The Department of Defense does not collect financial data regarding the value of special tooling, special test equipment, and military property held by contractors. However, Department records show that as of June 30, 1966, the cost of facilities in the hands of contractors amounted to \$6.2 billion. This amounted to an increase of \$700 million over that reported at June 30, 1965. About \$300 million of this increase is attributed to the inclusion in inventory records of several Government-owned plants that had been inactive. The remainder is primarily applicable to increases in the amount of industrial plant equipment provided to Army and Air Force contractors. Comparable data for the period ended June 30, 1967, is not yet available.

One of the factors contributing to the rise in the value of Government-owned property held by contractors is the Department's program for modernization and replacement of Government-owned machine tools. Annual expenditures for this program averaged about \$27.4 million during the period 1958 through 1963. Fiscal year 1966 expenditures amounted to \$51.5 million, and expenditures of \$65.8 million were forecast for the fiscal year 1967.

So long as the Government continues to furnish facilities to contractors and continues the tooling modernization and replacement program, the large Government investment in machine tools will tend to increase.

OEP Approval for Commercial Use

The Department of Defense allows rent-free use of its facilities for military orders.

In June 1957, the Office of Emergency Planning established a requirement for contractors to obtain advance approval to use Government-owned machine tools on commercial work exceeding 25 percent of the total usage. The procedure for prior approval was established primarily to preclude contractors from obtaining a favored competitive position through rent-free use of Government-owned production equipment on commercial work.

Generally, we found from our review of the records covering the years 1965 and 1966 that contracting officers were not requiring contractors to request and contractors were not requesting approval to use Government-owned industrial plant equipment for commercial work in excess of the 25-percent criteria. The Armed Services Procurement Regulation does not precisely define what constitutes "25 percent non-Government use." It is not clear whether the criteria refers to total planned use or a portion of manufacturing hours available under one or more work shifts, or if it is to be administered on a total plant or an item-by-item basis.

Insofar as we can determine, the approval obtained from the Office of Emergency Planning places no restriction on the extent to which a contractor may use the facilities on commercial work provided rental payments are made.

Although uniform rates for the rental of Government-owned machines to contractors have been prescribed, as currently stated in Defense Mobilization Order 8555.1 of the Office of Emergency Planning and Section 7-702.12 of the Armed Services Procurement Regulation, we found that the various bases upon which the rent payments were negotiated

resulted in a lack of uniformity in the rates actually charged, inequities between contractors, and in some cases, reduced rent payments to the Government. This occurs because the Regulation allows and contractors compute rent based on overall allocations of the workload between Government and non-Government work according to the relationship of various factors--such as sales, labor hours, or machine hours--rather than computing rent machine-by-machine according to the ratio of shared usage of the particular machine.

Disposition of Government-Furnished Property

To promote the maximum utilization within the Government, serviceable or usable property is required to be screened prior to disposition.

The Armed Services Procurement Regulation provides that Government-furnished property, return of which has not been required by the Government at the conclusion of Government work, may be disposed of either by competitive sales or by negotiation. With respect to the latter, sales are required to be made at prices which are fair and reasonable, and not less than the proceeds that could reasonably be expected to be obtained if the property were offered for competitive sale.

Mr. Chairman, in addition to the areas I have just covered, we will be pleased to discuss any other matters you consider pertinent to your Committee's current areas of inquiry.

EXCERPTS FROM DEFENSE PROCUREMENT CIRCULAR #57, 11-30-67

Agency Audit Rights

"ITEM IV--REVISED AUDIT CLAUSES

To provide adequate contractual coverage for access rights to contractor's records necessary to perform post-award reviews, when required under Public Law 87-653, changes have been made in the clauses in ASPR 7-104.41. Effective as soon as received, these revised clauses will be used in contracts as provided in 7-104.41 herein. ***."

"7-104.41 Audit and Records

(a) Insert the following clause only in firm fixed-price and fixed-price with escalation negotiated contracts which when entered into exceed \$100,000 except where the price negotiated is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. ***."

"AUDIT (NOV. 1967)

(a) For purposes of verifying that certified cost or pricing data submitted, in conjunction with the negotiation of this contract or any contract change or other modification involving an amount in excess of \$100,000, were accurate, complete, and current, the Contracting Officer, or his authorized representatives, shall--until the expiration of three years from the date of final payment under this contract--have the right to examine those books, records, documents, papers and other supporting data which involve transactions related to this contract or which will permit adequate evaluation of the cost or pricing data submitted, along with the computations and projections used therein.

(b) The Contractor agrees to insert this clause including this paragraph (b) in all subcontracts hereunder which when entered into exceed \$100,000, unless the price is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. When so inserted, changes shall be made to designate the higher-tier subcontractor at the level involved as the contracting and certifying party; ***."

Similar clauses have been provided for price adjustment to formal advertised contracts, and negotiated contracts that are not firm fixed price.

EXCERPTS FROM DEFENSE PROCUREMENT CIRCULAR #57, 11-30-67

Recovery from Subcontractors

"3-807.5 Defective Cost or Pricing Data

(d) Under 10 U.S.C. 2306(f) and the "Price Reduction for Defective Cost or Pricing Data" clauses set forth in 7-104.29, the Government's right to reduce the prime contract price extends to cases where the prime contract price was increased by any significant sums because a subcontractor furnished defective cost or pricing data in connection with a subcontract where a certificate of cost or pricing data was or should have been furnished. ***."

"Paragraphs 3-807.5(d) and (e), which are concerned with the area of subcontractor coverage, are still under study and may be revised in the near future. In event of revision, the clause in 7-104.29 will likewise be revised."