DEPARTMENT OF DEFENSE

AUDIT REPORT

SUMMARY REPORT ON THE AUDITS OF CONTRACT TERMINATIONS

No. 90-010 November 21, 1989

Office of the Inspector General

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

November 21, 1989

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)

SUBJECT: Summary Report on the Audits of Contract Terminations (Report No. 90-010)

This is our final summary report on the Audits of Contract Terminations for your information and use. Comments on a draft of this report were considered in preparing the final report. The report summarizes the results of three recent audits of contract terminations (Appendix A). The audits were made from November 1985 through August 1988 by the Inspector General, DoD, and the General Accounting Office. The primary objective of the audits was to determine the effectiveness of processes and procedures that managers at inventory control points in the Army, Navy, and Air Force used in deciding whether or not to terminate unneeded spare parts from existing contracts. In total, the 13 Service inventory control points reported about $3.5 billion of unneeded spare parts (excess on-order assets) due-in from contractors at the time of the audits. The three audits included tests of $1.8 billion of excess on-order assets that 5 of the 13 inventory control points reported.

The three audits concluded that the Services did not have effective processes and procedures for making economical contract termination decisions at inventory control points. Overall, the five inventory control points terminated from 2.4 to 8.6 percent of the values of their excess on-order assets, while the audits showed that it would have been more economical to terminate from 36.0 to 78.0 percent of such assets from contracts. The audits also concluded that the Services will not be able to establish effective and efficient termination decisionmaking processes until their managers can accurately quantify the value of excess assets on contracts. Additionally, the Services did not take advantage of opportunities to use excess on-order assets that were not terminated as Government-furnished material on other contracts. As such, the excess on-order assets were brought into inventory, and the Services paid contractors to make or buy the same assets for other contracts.

During and after the audits, the Services took, and planned to take, numerous actions to correct conditions identified by the audits. For example, the Services reportedly terminated from contracts $29.4 million of $36.8 million of excess on-order assets that we and the General Accounting Office recommended for immediate termination. The Air Force developed a cost model for

its inventory control points to use in deciding when it was economical to terminate unneeded assets from contracts. Further, according to data provided by the Air Force, the use of the cost model substantially increased the extent of contract terminations. The Air Force terminated only $1.8 million (2.4 percent) of $74.2 million of excess on-order assets that the General Accounting Office evaluated at two Air Force inventory control points. After developing and using a cost model, the Air Force terminated $116.9 million (17.8 percent) of $655.7 million of excess on-order assets at its five inventory control points as of March 31, 1988. The Army and Navy had not yet established cost models for termination decisionmaking, but they have committed to do so. Other noteworthy commitments by the Army and Navy were their plans to develop procedures to improve the accuracy of excess on-order asset positions and to use excess on-order assets as Government-furnished material, when economical.

Despite the responsiveness and significance of actions taken and planned by the Services on the results of the audits, further improvements are needed. To address those needed improvements, we have summarized in the following paragraphs the major conditions identified by the three audits, the Services' responses to recommendations stemming from the audits, and the additional improvements needed to correct the conditions. In Part II of this report, we provide details on the conditions, management actions, recommended improvements, and management comments.

About $1.1 billion of excess on-order assets at three of the Army's and Navy's inventory control points were overstated by about $517.1 million (46.1 percent). Until the inventory control points achieve accurate values of excess on-order assets, they will not be able to achieve effective and efficient termination decisionmaking processes because requesting terminations for inaccurate quantities can lead to either too few or too many assets being terminated from contracts. To achieve accurate values of excess on-order assets, we made five recommendations to the Army and Navy in audit reports. The Army and Navy concurred with all five recommendations. Based on actions planned by the Army and Navy to improve the accuracy of excess on-order asset positions, we did not include any recommendations on that matter in this report. However, due to the importance of establishing excess on-order asset positions before making termination decisions, we are providing in Part II of this report summaries of our findings on excess on-order asset positions, of our recommendations to the Army and Navy, and of the actions that the Army and Navy plan to take on our recommendations (page 7).

Managers at inventory control points made uneconomical termination decisions on 58 (52.3 percent) of the 111 sample items evaluated in the audits. In dollar value, the audits showed that the managers made termination decisions on $460.1 million of excess on-order assets, and the decisions on $190.2 million of those assets were not cost-effective. As a result of uneconomical termination decisions, the inventory control points could incur $121.9 million a year in unnecessary expenditures. Additionally, managers at one inventory control point did not consider $112.8 million of excess on-order assets for termination. As a result, that inventory control point made an additional $15.9 million of unnecessary expenditures for assets that could have been terminated. To improve the termination decisionmaking processes, we and the General Accounting Office made seven recommendations to the Services. The Services agreed with all seven recommendations. However, additional improvements were needed. We recommended that the Assistant Secretary of Defense (Production and Logistics) establish policy and procedures on contract termination decisionmaking and establish procedures requiring performance evaluation systems that the Services can use to monitor inventory control points' compliance with DoD contract termination procedures (page 13).

Three inventory control points in the Army and Navy had opportunities to reduce the cost consequences resulting from uneconomical termination decisions, but they did not take advantage of such opportunities. Specifically, the inventory control points could have arranged for excess on-order assets that were not terminated and that applied to higher assemblies in production to be used as Government-furnished material on production contracts for the higher assemblies. As a result, we projected that the three inventory control points unnecessarily brought $156.9 million of excess on-order assets into inventory. To avoid such unnecessary inventory investments, we made five recommendations to the Army and Navy. The Army and Navy agreed with all five recommendations. However, we believe additional actions are required. We recommended that the Assistant Secretary of Defense (Production and Logistics) revise and supplement three existing and one proposed Defense policy documents that provide guidance on the use of assets as Government-furnished material (page 31).

The audits at the Army's and Navy's inventory control points also identified material internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. One internal control weakness was the absence of controls over the completeness and timeliness of item managers' validations of excess on-order asset positions and contracting officers' termination decisions. Another internal control weakness was the lack of quality checks or supervisory reviews of item managers' validations of excess

on-order asset positions. Other internal control weaknesses were the absences of procedures specifying how to make termination decisions; requiring managers to use, as Government-furnished material, excess on-order assets that were not terminated from contracts; and requiring verification of the values of final excess on-order asset positions. In our audit reports to the Army and Navy, we made seven recommendations that, if properly implemented, should greatly improve the internal control weaknesses. Management agreed to act on all seven recommendations. A copy of this report is being provided to the senior officials responsible for internal controls in the Army and Navy.

On July 31, 1989, we provided a draft of this report to the Assistant Secretary of Defense (Production and Logistics) for review and comments. On October 2, 1989, we received comments from the Assistant Secretary. A complete text of management's comments is included in Appendix G.

Management's comments to the draft report did not fully comply with the requirements of DoD Directive 7650.3. The Assistant Secretary concurred "in principle" with Recommendations B.1. and B.5., which provided for him to revise DoD's termination policy and to finalize and issue the Draft DoD Instruction on termination decisionmaking. However, the Assistant Secretary did not specify whether or not our recommended actions would be adopted because of an ongoing Defense Management Review of DoD Directives and DoD Instructions. He explained that the Defense Management Review had imposed a moratorium on new and revised DoD Directives and DoD Instructions until December 15, 1989. We ask the Assistant Secretary to provide final comments on Recommendations B.1. and B.5. in response to this final report.

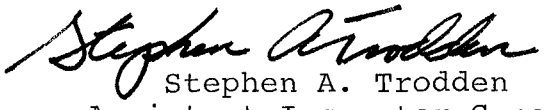
The Assistant Secretary concurred with the "intent" of Recommendations B.2. through B.4.d. and C.1. through C.4. However, he concluded that no actions were necessary on the recommendations. We disagree with the Assistant Secretary's conclusions and have described our reasons in Part II of this final report. We ask that the Assistant Secretary review our reasons for maintaining that actions are required on the recommendations and provide final comments on the recommendations.

We are not claiming any potential monetary benefits on recommendations in this report because those benefits were identified and claimed in each of the three previous audit reports that were issued to the Services. However, we would like to point out that establishing cost-effective termination decisionmaking processes and procedures for using excess on-order assets that cannot be economically terminated as Government-furnished material will be very cost-beneficial to the DoD. In our audit report to the Army, we projected that the Army could

realize about $483.3 million of potential monetary benefits from fiscal years 1989 through 1993 by correcting the conditions that we identified at two Army inventory control points. In our report to the Navy, we projected that about $49.7 million of annual recurring benefits and $134.9 million of one-time benefits could be realized at one Navy inventory control point. The General Accounting Office claimed in its report to the Air Force that two Air Force inventory control points could save from $11.9 million to $36.8 million a year by making cost-effective terminations. Based on the amount of potential monetary benefits identified by the audits at 5 of the Services' 13 inventory control points, we conservatively estimate that for the 13 inventory control points, the potential benefits to DoD when conditions identified by the audits are corrected may exceed $200 million annually or $1 billion over a 5-year period.

DoD Directive 7650.3 requires that all audit recommendations be resolved within 6 months of the date of the final report. Accordingly, we ask that you provide specific descriptions of the actions that you plan to take on all recommendations, as well as estimated completion dates of those actions, within 60 days of the date of this memorandum.

The courtesies extended to the audit staff are appreciated. The list of audit team members is in Appendix I. If you have any questions on this audit, please contact Mr. David K. Steensma, Program Director, at (202) 694-1681 (AUTOVON 224-1681) or Mr. Rayburn H. Stricklin, Project Manager, at (202) 694-3965 (AUTOVON 224-3965). Copies of this final report are being provided to the activities listed in Appendix J.



Stephen A. Trodden
Assistant Inspector General
for Auditing

Enclosures

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force
Director, Defense Acquisition Regulatory Council

SUMMARY REPORT ON THE AUDITS OF CONTRACT TERMINATIONS

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Prepared by:
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SUMMARY REPORT ON THE AUDITS OF CONTRACT TERMINATIONS

PART I - INTRODUCTION

Background

Within the DoD supply system, activities called inventory control points manage spare parts. These inventory control points are under the Services or the Defense Logistics Agency and procure spare parts based on records of reported inventory, historical use, repair rates, and approved force-level requirements. The inventory control points award contracts for spare parts that may later become excess to current requirements because requirements change from those prevalent at the time of the procurement. For example, when changes occur in mission, authorizations, or quantities of weapon systems being supported, the need for on-hand and on-order spare parts may also change. Additionally, changes in demand, attrition, repair, and other factors that justified procurement of the spare parts can cause inventory control points to acquire unneeded parts from contractors.

Within the Services, there are 13 inventory control points. At the time of our and the General Accounting Office's audits (from September 30, 1985, through September 30, 1987), the inventory control points had about $3.5 billion of spare parts due-in from contractors that were excess to their needs (excess on-order assets) (Appendix B). The five inventory control points that the Inspector General, DoD, and the General Accounting Office audited had $1.8 billion of excess on-order assets, as shown below.

	Excess On-Order Assets		
Inventory Control Point	Items	Value (millions)	As of Date
Army:			
Aviation Systems Command	7,775	$ 240.8	June 30, 1987
Tank-Automotive Command	3,773	167.4	September 30, 1987
Navy:			
Aviation Supply Office	5,022	712.8	September 30, 1986
Air Force:			
Sacramento Air Logistics Center	886	88.1	September 30, 1985
San Antonio Air Logistics	1,271	599.7	September 30, 1985
Total	18,727	$1,808.8	

The Services' regulations did not specifically address how managers should make termination decisions. However, in practice, the Services' inventory control points used a four-part process to identify and terminate unneeded assets on contracts, as described in the following paragraphs.

Initially, the Services' automated requirements computation systems (the computation systems) computed requirements for material needed to fill customer requisitions and to meet other obligations. The computation systems compared the computed requirements with the material on hand and on order. When the computation systems identified on-order assets that were excess to requirements, they generated requirement computations that showed the number of on-order assets excess to requirements objectives.

Second, item managers validated the accuracy of data that the computation systems used in computing excess assets to determine whether the assets were actually excess. Item managers either confirmed that the data were accurate or determined that the data were not accurate and requested the file maintenance actions necessary to correct erroneous data in the computation systems.

Third, if excess on-order assets still existed after the data validation and file maintenance actions, item managers were required to request that contracting officers consider contract termination actions for the excess assets.

Finally, contracting officers were required to make decisions on potential terminations for the excess on-order assets referred by item managers. Section 49.101 of the Federal Acquisition Regulation requires that contracting officers terminate unneeded assets from contracts when it is in the Government's best interest.

Objectives and Scope

The primary objective of our audits and the General Accounting Office's audit of contract terminations was to determine the effectiveness of processes and procedures that managers at inventory control points in the Army, Navy, and Air Force used in deciding whether or not to terminate unneeded spare parts from existing contracts.

To accomplish the objective, we and the General Accounting Office selected for review samples of line items that computation systems and item managers at five inventory control points (two Army, one Navy, and two Air Force) identified as having excess on-order assets. In Appendix C, we describe how the samples were selected. In total, the samples consisted of 344 line items with $760.0 million (42.0 percent) of excess on-order assets of the total excess on-order assets ($1,808.8 million) that the five inventory control points identified at the time of the audits.

Inventory Control Point	Excess On-Order Assets			
	Total		Audit Sample	
	Items	Value (millions)	Items	Value (millions)
Army:				
Aviation System Command	7,775	$ 240.8	100	$109.2
Tank-Automotive Command	3,773	167.4	100	117.9
Navy:				
Aviation Supply Office	5,022	712.8	100	91.0
Air Force:				
Sacramento Air Logistics Center	886	88.1	19	30.7
San Antonio Air Logistics Center	1,271	599.7	25	411.2
Total	18,727	$1,808.8	344	$760.0

For the selected items, we and the General Accounting Office obtained and reviewed item managers' validations of excess on-order asset positions to determine the validity of the stated positions, and evaluated termination decisions made for on-order assets that we and the General Accounting Office concluded were excess to the inventory control points' requirements. To evaluate termination decisions, we and the General Accounting Office used an economic analyses approach that provided for comparing the cost of terminating the excess on-order assets with the cost of taking delivery of the excess on-order assets and storing them until used. To calculate the costs necessary for the cost comparisons, we and the General Accounting Office obtained cost data from contractors, the U.S. Department of the Treasury, and contract administration officials.

We also made tests at the two Army and one Navy inventory control points included in our audits to determine whether any of the excess on-order assets in our samples applied to higher assemblies that were scheduled for production. For such assets, we also determined whether the inventory control points used, or planned to use, the assets as Government-furnished material on production contracts rather than retaining such assets in inventory or terminating the assets from contracts.

Finally, the audits included reviews of internal control program documentation at the two Army and one Navy inventory control points that we selected for audit. We reviewed the program documentation to determine the extent of controls over the termination decisionmaking processes and the results of vulnerability assessments of those controls. We found that the program documentation at all three inventory control points did not show internal control weaknesses in the processes used to terminate unneeded assets from contracts. Specifically, the inventory control points' documentation did not identify weaknesses in the timeliness and completeness of item managers' validations of excess on-order assets and contracting officers'

termination decisions. Further, the documentation did not show weaknesses in quality checks and supervisory reviews of item managers' validations of excess on-order asset positions. Other weaknesses that were not shown in the documentation included the absence of procedures specifying how to make termination decisions; the requirement that managers use, as Government-furnished material, excess on-order assets that were not terminated from contracts; and the requirement that final excess on-order asset positions be verified.

The economy and efficiency audits were made from November 1985 through August 1988 and included reviews of records dated from August 1984 through August 1988. The General Accounting Office's audits were made in accordance with generally accepted government auditing standards, and our audits were made in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, our audits included tests of internal controls as were considered necessary. A list of the activities visited or contacted during the audits is in Appendix H.

Prior Audit Coverage

Since 1984, there have been eight audit reports issued on contract termination procedures in the DoD. All the reports, which are listed below and described briefly in Appendix D, pointed out that the inventory control points made uneconomical termination decisions. Further, the main reason for the uneconomical decisions was the lack of policies and procedures on how to make decisions.

Office of the Inspector General, DoD, Report No. 89-063, "Contract Terminations at Army Inventory Control Points," March 29, 1989.

Office of the Inspector General, DoD, Report No. 89-040, "Quick-Reaction Report on the Audit of Contract Terminations at the Tank-Automotive Command," December 14, 1988.

Office of the Inspector General, DoD, Report No. 89-004, "Quick-Reaction Report on the Audit of Contract Terminations at Army Inventory Control Points," October 13, 1988.

Office of the Inspector General, DoD, Report No. 88-172, "Quick-Reaction Report on the Audit of Contract Terminations at Army Inventory Control Points," June 17, 1988.

Office of the Inspector General, DoD, Report No. 88-153, "Contract Terminations at the Navy Aviation Supply Office," May 23, 1988.

General Accounting Office Report No. GAO/NSIAD-87-141 (OSD Case No. 7242), "Military Procurement: Air Force Should Terminate More Contracts for On-Order Excess Spare Parts," August 12, 1987.

General Accounting Office Report No. GAO/NSIAD-85-55 (OSD Case No. 6670), "The Navy Can Increase Cancellations of Procurements for Unneeded Material," March 22, 1985.

General Accounting Office Report No. GAO/NSIAD-84-42 (OSD Case No. 6370), "Defense Logistics Agency Could Better Identify and Cancel Unneeded On-Order Material," January 10, 1984.

PART II - FINDINGS AND RECOMMENDATIONS

A. Excess On-Order Assets

FINDING

Item managers did not accurately quantify the value of excess on-order assets before making termination decisions. Item managers misstated the value of excess on-order assets at two Army and one Navy inventory control points on 209 (69.7 percent) of 300 line items that we evaluated. In total, the values of excess on-order assets ($1.1 billion) at the three inventory control points were overstated by a projected $517.1 million (46.1 percent). The values were inaccurate because item managers made incomplete validations of data used by automated requirements computation systems (computation systems) to compute excess on-order positions, because item managers made unjustified and unauthorized changes to data in the computation systems, and because supervisory reviews and final verifications of excess on-order asset positions were absent. Until inventory control points achieve accurate values of excess on-order assets, they will not be able to achieve an effective and efficient termination decisionmaking process because requesting terminations for inaccurate quantities of excess on-order assets could lead to either too many or too few assets being terminated from contracts.

DISCUSSION OF DETAILS

Background. The Army and Navy used a four-part process for termination decisionmaking. The first two parts of the process involved identifying and quantifying excess assets on contracts. More specifically, the two Services' computation systems computed requirements for material needed to fill customer requisitions and to meet other obligations. The computation systems compared the computed requirements with the material on hand and on order. When the computation systems identified on-order assets that were excess to requirements, they generated documents that showed the number of on-order assets excess to requirements objectives. Item managers were required to validate the accuracy of data that the computation systems used in computing excess assets and to determine whether the assets were actually excess. Item managers either confirmed that the data were accurate or determined that the data were not accurate and requested the file maintenance actions necessary to correct erroneous system data.

By applying the first two parts of the termination decisionmaking process, the Army and Navy inventory control points included in our audits identified 16,570 line items that had $1.1 billion of excess on-order assets at the time of the audits.

Inventory Control Point	Excess On-Order Assets		
	Items	Value (millions)	As Of
Army:			
Aviation Systems Command	7,775	$240.8	June 30, 1987
Tank-Automotive Command	3,773	167.4	September 30, 1987
Navy:			
Aviation Supply Office	5,022	712.8	September 30, 1986
Total	16,570	$1,121.0	

Audit of Item Managers' Validations of Excess On-Order Assets. As part of our audits of contract terminations at the three Army and Navy inventory control points, we reviewed samples of item managers' validations of line items that had excess on-order assets. The randomly selected sample consisted of 300 items (100 items at each inventory control point) that had $318.1 million of excess on-order assets. The $318.1 million represented 28.4 percent of the $1.1 billion of excess on-order assets identified by the three inventory control points for the periods selected for audit.

Inventory Control Point	Value of Excess On-Order Assets	
	Total	Audit Sample (millions)
Army:		
Aviation Systems Command	100	$109.2
Tank-Automotive Command	100	117.9
Navy:		
Aviation Supply Office	100	91.0
Total	300	$318.1

Our review of the validations disclosed that the value of excess on-order assets on 209 of the 300 items was incorrect. On the 200 line items that we reviewed at the two Army inventory control points, item managers overstated excess on-order assets on 94 line items by $121.4 million and understated excess on-order assets on 31 line items by $17.7 million. On the 100 line items at the Navy inventory control point, the value of excess on-order assets was overstated by $54.3 million on 69 line items and understated by $2.9 million on 15 line items. In net terms, the two Army inventory control points overstated the value of excess on-order assets by $103.7 million. The item managers at the Navy inventory control point overstated the value of excess on-order assets by a net amount of $51.4 million.

To provide further insight on the extent that the item managers overstated excess on-order assets, we statistically projected the net amount that excess on-order assets were overstated on the 300 sample items to the value of excess on-order assets identified by item managers at the three inventory control

points. Our projections showed that, in total, the value of excess on-order assets ($1.121 billion) was overstated by $517.1 million (46.1 percent).

Inventory Control Point	Projected Overstatement of Excess On-Order Assets (millions)
Army:	
Aviation Systems Command	$ 93.4
Tank-Automotive Command	71.7
Navy:	
Aviation Supply Office	352.0
Total	$517.1

There were several reasons for the value of excess on-order assets being misstated. First, item managers at the three inventory control points did not identify and correct erroneous data that the computation systems used to calculate excess on-order asset positions. Second, item managers at Army inventory control points did not verify that changes, which they attempted to make to data in the computation systems, were actually made. Third, item managers at the Aviation Supply Office made unjustified and unauthorized changes to requirements and asset data in their computation systems. Last, supervisory personnel did not evaluate item managers' validations of excess on-order asset positions.

Effects of Misstated Excess On-Order Assets. Until the Army and Navy inventory control points correct the problems causing inaccurate excess on-order assets positions, the Services will not be able to establish effective and efficient termination decisionmaking processes for three reasons.

First, item managers cannot request termination actions until they have accurate values of excess on-order assets. Inaccurate values can lead to either too many or too few assets being terminated from contracts. For example, the Aviation Supply Office did not identify, and consider for termination, $17.5 million of excess on-order assets due to errors in item managers' validations on 17 items. Further, $15.7 million of those assets on 13 of the items should have been, but were not, terminated. Since the assets were not terminated, the Aviation Supply Office made $16.6 million of unnecessary expenditures. By statistically projecting those audit results to the value of excess on-order assets at the Aviation Supply Office, we concluded that inaccurate excess on-order asset positions resulted in item managers not identifying the need to terminate $79.5 million of excess on-order assets from the contracts. Also, we projected that the Aviation Supply Office made $39.2 million of unnecessary expenditures as a result of not identifying and terminating the $79.5 million of excess on-order assets.

Second, the Services cannot monitor and evaluate the effectiveness of their termination decisionmaking processes. With inaccurate values of excess on-order assets, the Services had no baselines to measure accurately the extent of terminations and the timeliness of termination decisions.

Finally, unless the values of excess on-order assets are corrected in the computation systems, the item managers must review incorrect items each time the computation systems identify excess on-order assets.

Initiatives on the Part of Management During the Audits. On April 20, 1987, the Director for Operations at the Aviation Supply Office issued Policy and Procedures Memorandum Number 207, "Review of SDR Termination Recommendations." (SDR stands for Supply Demand Reviews.) The memorandum requires that supervisors review and approve all item managers' validations of excess on-order assets and requires increasing levels of management review and approval of validations on higher dollar value items. Compliance with the memorandum should greatly reduce the types of errors that we found in item managers' validations at the Aviation Supply Office.

Actions Recommended to Management During the Audits. To improve the accuracy of excess on-order asset positions at the Army inventory control points, we recommended that the Army establish procedures requiring its inventory control points to establish additional oversight controls over item managers' validation of excess on-order assets. We also recommended that additional oversight controls be established over automated input of requirements and asset data needed to achieve accurate final values of excess on-order assets. Further, we recommended that, as a minimum, the controls include a verification of the accuracy of final excess on-order asset positions for all items over a predetermined dollar value.

To improve the accuracy of excess on-order asset positions at the Navy's Aviation Supply Office, we recommended that the Commander, Aviation Supply Office, develop and implement procedures that specify the scope of supervisors' review of item managers' validations of excess on-order asset positions. We also recommended that the Commander, Aviation Supply Office, establish critical elements in applicable personnel performance appraisals covering item managers' validations and supervisors' reviews of those validations. Further, we recommended that the Commander, Aviation Supply Office, update procedures that show organizational elements responsible for authorizing and approving changes to requirements and asset data. Last, we recommended that the Commander, Aviation Supply Office, establish training programs that instruct item managers and their supervisors on the criteria that they should use to evaluate, review, and approve validations of excess on-order asset positions.

Actions Taken by Management on Audit Recommendations. The Army and Navy concurred with our audit recommendations and stated that they would initiate actions to improve the accuracy of excess on-order assets at all of their inventory control points. Specifically, the Army stated that it would use data base maintenance task groups and its stratification review process (a process used to develop budget requirements) to improve the accuracy of excess on-order asset positions. The Navy replied that it would improve and reemphasize procedures for quality reviews of item managers' validations of excess on-order asset positions, include critical elements in performance plans covering validations of excess on-order assets for all personnel associated with the validations, issue a policy memorandum specifying the authorization and approval process for changes to requirements data, and require that all item managers be trained on validating excess on-order validations.

RECOMMENDATION FOR CORRECTIVE ACTION

We are making no further recommendations on this finding. The actions planned by the Army and Navy should improve the accuracy of excess on-order asset positions.

MANAGEMENT COMMENTS

Management did not provide any comments on this finding.

B. Termination Decisions

FINDING

Managers at the five inventory control points made uneconomical termination decisions because they did not have policies and procedures that specified how to make those decisions. As a result of the uneconomical termination decisions, the inventory control points could incur $121.9 million a year in unnecessary expenditures. In addition, we concluded that the item managers at Navy's Aviation Supply Office did not consider a projected $112.8 million of excess on-order assets for termination because the Aviation Supply Office established a dollar threshold for termination reviews that eliminated the on-order assets from termination considerations. As a result of the on-order assets not being considered for termination, DoD incurred an additional $15.9 million of unnecessary expenditures.

DISCUSSION OF DETAILS

Background. Section 49.101 of the Federal Acquisition Regulation, "Authorities and Responsibilities," which addresses the authorities and responsibilities of contracting officers in dealing with contract terminations, states that contracting officers will terminate contracts for the Government's convenience when it is in the Government's best interest.

Although contracting officers were responsible for making termination decisions, they were not provided with guidance that specified exactly how to determine when it is in the Government's best interest to terminate unneeded assets from contracts. In Appendix E, we summarize the procedures that the Services provided to item managers and contracting officers for termination decisionmaking. As discussed in Appendix E, the Services' procedures mainly addressed the process that item managers and contracting officers at inventory control points should use when considering excess on-order assets for termination. The Services' procedures also addressed various factors that item managers should consider before requesting that contracting officers terminate excess on-order assets from contracts. The Air Force's procedures addressed various factors that contracting officers should consider when deciding whether or not to terminate excess on-order assets from contracts. However, those factors did not contain the specificity necessary to achieve economical termination decisions.

In the absence of procedures for deciding when it was economical to terminate excess on-order assets from contracts, we and the General Accounting Office developed economic analyses to use when evaluating termination decisions during the audits. The analyses that we used to evaluate termination decisions at the three Army and Navy inventory control points included in our audits

consisted of comparing the cost of terminating excess on-order assets to the cost of taking delivery and retaining those assets in inventory. When estimating termination costs, we considered costs incurred up to the point of the termination decisions (less any costs that could be transferred to other contracts), plus profit and the cost of administering the termination. We also considered the cost of money in estimating termination costs. When estimating retention costs, we included the cost of financing and storing the assets in the inventory until the assets were totally expended. To make the analyses, we obtained contract costs from contractors, administrative and storage costs from the 1987 General Accounting Office report addressing Air Force contract terminations (see Prior Audit Coverage), and interest costs from the U.S. Department of Treasury for the cost of financing inventory investment. Finally, to complete our economic analyses, we compared the output of our analyses on whether terminations were cost-effective to the termination decisions made by the Services' officials. We quantified any unnecessary costs resulting from those decisions.

The General Accounting Office used a similar cost comparison analysis to evaluate termination decisions at two Air Force inventory control points. When estimating the costs of terminating items, the General Accounting Office included incurred costs that contractors reported, contractor administrative costs, Air Force administrative costs, and reprocurement costs. When estimating the cost of not terminating excess on-order assets, the General Accounting Office included acquisition, transportation, and inventory holding costs.

Termination Decisions. On the 344 items with $760.0 million of excess on-order assets selected for the audits, item managers and contracting officers made termination decisions on 219 items, valued at $216.8 million, that had excess on-order assets. The 4 Army and Air Force inventory control points included in the audits did not make termination decisions on 53 of the sample items because the item manager's validations disclosed that none of the on-order assets on the 53 sample items were excess to requirements. The Navy's Aviation Supply Office did not make termination decisions on 72 sample items for 2 reasons. First, item managers' validations disclosed that there were no excess on-order assets on 26 sample items. Second, item managers did not consider 46 sample items for termination because the value of excess on-order assets on each of the items was less than the $170,700 dollar threshold that the inventory control point established for termination reviews. Later in this finding we will discuss the cost consequences of the Navy's inventory control point not considering the 46 sample items for termination.

The following table shows the number of termination decisions made on the sample items at each inventory control point.

Inventory Control Point	Excess On-Order Assets			
	Audit Samples		Termination Decisions	
	Items	Value (millions)	Items	Value (millions)
Army:				
Aviation Systems Command	100	$109.2	75	$ 64.3
Tank-Automotive Command	100	117.9	82	59.1
Navy:				
Aviation Supply Office	100	91.0	28	19.2
Air Force:				
Sacramento Air Logistics Center	19	30.7	16	17.0
San Antonio Air Logistics Center	25	411.2	18	57.2
Total	344	$760.0	219	$216.8

Of the 219 sample items with termination decisions, item managers decided that termination actions were not appropriate on 166 items that had $177.3 million of excess on-order assets. On the other 53 items, item managers requested that contracting officers terminate $39.5 million of excess on-order assets from applicable contracts. Contracting officers terminated only $9.0 million of excess on-order assets on 13 of the 53 items. The following table shows the termination decisions at each inventory control point included in the audits.

Inventory Control Point	Decisions to			
	Terminate		Not Terminate	
	Items	Value (millions)	Items	Value (millions)
Army:				
Aviation Systems Command	3	$2.3	72	$ 62.0
Tank-Automotive Command	3	1.5	79	57.6
Navy:				
Aviation Supply Office	4	3.4	24	15.8
Air Force:				
Sacramento Air Logistics Center and San Antonio Air Logistics Center	3	1.8	31	72.4
Total	13	$9.0	206	$207.8

To evaluate the 219 termination decisions that were made at the inventory control points, we and the General Accounting Office first selected for evaluation all 13 items that were terminated and 98 of the 206 items that were not terminated. In total, the 111 selected items had $137.6 million of excess on-order assets. The following table shows the number and value of items selected for evaluation at each inventory control point.

Inventory Control Point	Decisions Selected for Evaluation			
	Decisions to			
	Terminate		Not Terminate	
	Items	Value (millions)	Items	Value (millions)
Army:				
Aviation Systems Command	3	$2.3	23	$ 20.9
Tank-Automotive Command	3	1.5	24	22.6
Navy:				
Aviation Supply Office	4	3.4	20	12.7
Air Force:				
Sacramento Air Logistics Center and San Antonio Air Logistics Center	3	1.8	31	72.4
Total	13	$9.0	98	$128.6

For each of the 111 items selected for evaluation, we and the General Accounting Office gathered the cost and production data necessary to make economic analyses of the inventory control points' termination decisions. Additionally, on the 67 decisions evaluated at the 3 Army and Navy inventory control points, we reviewed excess on-order positions in prior computation periods to determine whether it would have been possible to terminate unneeded assets earlier when contract costs were less.

Our and the General Accounting Office's economic analyses disclosed that contracting officers' decisions to terminate at the 5 inventory control points were cost-effective for 12 of the 13 decisions that were analyzed. The decisions on 12 of the items were cost-effective because it cost DoD less to terminate the excess on-order assets on the items than to bring the assets into inventory. The decision on the other item was not cost-effective because our economic analyses showed that it cost the Tank-Automotive Command $16,706 more to terminate $87,168 of excess on-order assets than it would have cost to bring the assets into inventory and use them until depleted.

Our and the General Accounting Office's analyses of the 98 items that the inventory control points decided not to terminate disclosed that decisions were cost-effective on 41 of the items but not on the other 57 items. It would have cost the inventory control points less to terminate the excess on-order assets on the 57 items than not to terminate the assets. In Appendix F, we provide an example of uneconomical decisions not to terminate at each inventory control point. Also, the following table shows the number and value of uneconomical decisions at each inventory control point.

Inventory Control Point	Excess On-Order Assets On Decisions Not to Terminate			
	Analyzed		Uneconomical	
	Items	Value (millions)	Items	Value (millions)
Army:				
Aviation Systems Command	23	$20.9	9	$ 8.2
Tank-Automotive Command	24	22.6	17	15.8
Navy:				
Aviation Supply Office	20	12.7	16	11.1
Air Force:				
Sacramento Air Logistics Center and San Antonio Air Logistics Center	31	72.4	15	24.9
Total	98	$128.6	57	$60.0

Effects of Termination Decisions. As a result of the uneconomical termination decisions, we and the General Accounting Office concluded that the inventory control points made as much as $50.5 million of unnecessary expenditures. Additionally, the inventory control points incurred, and will continue to incur, unnecessary interest and storage costs until the excess on-order assets are used. The amount of unnecessary expenditures made by each inventory control point is shown below.

Inventory Control Point	Unnecessary Expenditures (millions)
Army:	
Aviation Systems Command	$ 6.1
Tank-Automotive Command	13.8
Navy:	
Aviation Supply Office	7.7
Air Force:	
Sacramento Air Logistics Center	4.4
San Antonio Air Logistics Center	18.5
Total	$50.5

To provide further insight into the cost consequences of the uneconomical decisions, we statistically projected the results of our analyses of the items on which the Army and Navy inventory control points made uneconomical decisions to the value of excess on-order assets at those inventory control points. We concluded that the three inventory control points made termination decisions on about $385.9 million of excess on-order assets and that decisions on about $165.3 million were not cost-effective. Further, we projected that the three inventory control points made $99.0 million of unnecessary expenditures as a result of the uneconomical decisions. The General Accounting Office did not

statistically project the $22.9 million of cost consequences that its auditors identified on uneconomical termination decisions at the two Air Force inventory control points. In total, the audits identified $121.9 million of unnecessary expenditures.

Reasons for Termination Decisions. The primary reason for the uneconomical decisions not to terminate excess on-order assets at all five inventory control points was a lack of analyses and comparisons of costs relative to terminating and not terminating excess on-order assets from contracts. The lack of analyses and comparisons at the Army and Navy inventory control points stemmed from an absence of policies and procedures requiring such efforts. The procedures at the Army's inventory control points addressed under what circumstances item managers should request that contracting officers terminate excess on-order assets from contracts (Appendix E). However, the inventory control points', the Army's, and the Navy's procedures did not address the basis on which contracting officers should make termination decisions. Also, the procedures did not specify the responsibilities of the various officials (item managers, contracting officers, administrative contracting officers, and contractors) that should be involved in termination decisions.

In the absence of policies and procedures for termination decisionmaking in the Army and Navy, item managers and contracting officers made termination decisions based on personal opinions. Generally, item managers based termination decisions on their assessments of the contractual status of assets being considered for termination. For example, if the contractors had delivered the assets or deliveries were scheduled to start in the near future, item managers would conclude that it was not economical to terminate and would not request termination actions. Contracting officers' decisions were based largely on whether or not terminations could be achieved at no cost to the Government. For instance, 7 of the 10 sample items that the Army's and Navy's contracting officers decided to terminate were terminated at no cost to the Government.

The General Accounting Office also concluded that termination decisions at the Air Force's inventory control points were made without cost analyses and comparisons due to a lack of adequate guidance and failure to comply with existing procedures.

First, the General Accounting Office stated that the Air Force's procedures required item managers and contracting officers to consider the cost of holding excess on-order assets when considering such assets for termination. However, item managers did not consider holding costs when they decided not to terminate because there was no guidance on how to calculate holding costs.

Second, the General Accounting Office stated that the Air Force's procedures required item managers to consider the amount of

elapsed production lead time when deciding to accept or terminate excess on-order assets. Item managers' interpretations of that requirement caused them to assume that termination would not be cost-effective if 10 percent or more of the total contract quantity had been received at the time of termination. However, the General Accounting Office's analyses and an Air Force Logistics Command's study showed that the assumption was causing item managers not to recommend excess on-order assets for termination although the assets should have been terminated.

Finally, the General Accounting Office stated that existing procedures required that item managers at the Sacramento Air Logistics Center and the San Antonio Air Logistics Center complete termination reviews within 10 and 25 workdays, respectively. The General Accounting Office concluded that item managers did not complete termination reviews on 23 sample items (52.3 percent) of 44 sample items within the required time frames. The General Accounting Office added that the termination reviews had required 30 or more workdays on eight sample items and 60 or more workdays on six other sample items.

As evidenced by the results of our and the General Accounting Office's economic analyses of decisions not to terminate items, neither the item managers' nor the contracting officers' methods of making termination decisions were totally cost-effective. To decide when it is cost-effective to terminate a contract, it is necessary to obtain from contractors reasonable estimates of what it will cost to terminate the contracts. Then, it is necessary to compare the potential termination costs with the cost of accepting and holding in inventory the excess on-order assets being considered for termination or with the cost of any other possible option. There is another option that should be considered in termination decisions. That option is to use the excess on-order assets that are being considered for termination as Government-furnished material on production contracts. When such use is possible, the Government does not incur any termination costs and incurs only minimal investment and holding costs. We will discuss the potential for using excess on-order assets as Government-furnished material in Finding C of this report.

Another reason for the uneconomical termination decisions at the Army and Navy inventory control points was the absence of management overviews of their termination decisionmaking processes. Army and Navy regulations did not require any overviews, and the three inventory control points that we visited during our audits were not monitoring and evaluating their performance when terminating excess on-order assets from contracts. If such monitoring and evaluating had been conducted, the inventory control points would have been aware of the limited value (from 3.1 to 8.6 percent) of the total value of excess on-order assets being terminated from contracts. Additionally,

management overview would have identified two other problems disclosed by our audit: extensive periods of time to make termination decisions and incomplete termination decisions. On the average, item managers took from 36 to 52 days to validate excess on-order assets and to prepare Request For Termination forms, and contracting officers took from 43 to 54 additional days to make termination decisions. Extensive processing periods further diminished termination potential because contract costs continued to be incurred during the processing period. Regarding incomplete termination actions, we noted that termination decisions on nine sample items that we analyzed were never finalized due to a lack of communication between contracting officers and item managers. Those nine items had $8.1 million of excess on-order assets, and our economic analyses showed that $3.5 million of the assets should have been terminated.

Excess On-Order Assets Not Subjected to Termination Decisions. As previously discussed on page 14, item managers at the Navy's Aviation Supply Office did not consider for termination excess on-order assets on 46 of the 100 items that we selected for evaluation. Item managers did not review 46 of the sample items because the value of excess on-order assets on each of the items was less than $170,700, which the Aviation Supply Office had established as the dollar threshold for termination reviews at the time of the audit.

To determine the effect of not considering the excess on-order assets on the 46 items for termination, we first reviewed the 46 sample items under the $170,700 threshold to determine how many of the items had on-order assets that were excess to requirements. We found that 36 items had $1.7 million of excess on-order assets. Next, we obtained contractual cost data for 19 of 36 items and compared that cost with the cost to hold the assets in inventory. The 19 items had $1.1 million of excess on-order assets.

Our reviews disclosed that $737,000 of excess on-order assets on 8 of the 19 items could have been terminated. By not terminating those excess on-order assets, the Aviation Supply Office made as much as $552,552 of unnecessary expenditures, and will incur unnecessary interest and storage costs to retain the unneeded assets in inventory.

To provide further insight into the consequences of not identifying excess on-order assets, we projected the results of our reviews of excess on-order assets on the 46 sample items to the value of all excess on-order assets at the Aviation Supply Office. Our projections showed that the Aviation Supply Office did not consider for termination $112.8 million of excess on-order assets because of the $170,700 threshold. Also, we projected that the Aviation Supply Office made $15.9 million of unnecessary expenditures as a result of not considering the assets for termination.

Aviation Supply Office officials informed us that they set the $170,700 threshold as part of their overall strategy, which was designed to reduce item managers' work load during two of the quarterly review cycles (March and September of each year) and still provide sufficient evaluations of excess on-order assets. More specifically, officials stated that during those review cycles, they increased the threshold for termination reviews because item managers had to evaluate items in both deficit and excess on-order positions. To compensate for increasing the threshold during the March and September review cycles, the officials informed us that during the other two review cycles (June and December), they required item managers to evaluate all excess on-order assets valued at $20,000 or more.

Although the officials' stated strategy appeared to provide for comprehensive evaluations of excess on-order assets every 6 months, the strategy had not been applied before the start of our audit. As shown below, the dollar thresholds used by the Aviation Supply Office from December 1985 through June 1987 show that the $20,000 threshold was not applied until January 1987, or 3 months after the review cycle that was in effect during our audit period.

Review Cycle	Threshold
December 1985	$300,000
March 1986	125,000
June 1986	300,000
September 1986	170,700
January 1987	20,000
March 1987	100,000
June 1987	20,000

Additionally, work load factors indicated that the Aviation Supply Office set the threshold too high for the September 1986 review cycle. We analyzed the termination work load in 1 of the 7 Inventory Management Branches in the Aviation Supply Office and found that with the $170,700 threshold, 73 of the 105 item managers in the Branch did not have any items to review. Also, 19 other item managers reviewed only 1 item each, 5 other item managers reviewed 2 items each, and 3 other item managers reviewed 3 items each.

Management Initiatives During the Audits. During the audits, the Army took a key step to improve its termination decisionmaking process. The Army established procedures requiring its inventory control points to base termination decisions on comparisons of termination costs with holding costs. Specifically, paragraph 4-9 of Army Regulation 710-1, "Centralized Inventory Management of the Army Supply System," March 1, 1988, specified:

> When changes in forecast requirements result in assets excess to the requirements objective, make a procurement order reduction or cancellation if the costs of the actions are less than the cost to hold. Cut back a procurement only if it is more economical than continuing the procurement. Reduction costs include administration cost of processing the reduction or cancellation and penalty costs imposed by the contractor. When there is more than one order, consider the last order placed first for such action.

Actions Recommended to the Services as a Result of the Audits. During the audits, we and the General Accounting Office recommended that the five inventory control points terminate $36.8 million of excess on-order assets that were on production contracts, as shown in the following table.

	Excess On-Order Assets Recommended for Termination	
Inventory Control Point	Items	Value (millions)
Army		
Aviation Systems Command	3	$ 3.0
Tank-Automotive Command	4	10.3
Navy:		
Aviation Supply Office	10	13.0
Air Force:		
Sacramento Air Logistics Center	3	3.5
San Antonio Air Logistics Center	2	7.0
Total	22	$36.8

At the completion of the audits in the Services, we and the General Accounting Office made several recommendations to improve the Services' termination decisionmaking processes. More specifically, we recommended that the Commander, Army Materiel Command, establish: procedures for contracting officers at Army inventory control points to use in making cost comparison analyses for cost-effective termination decisions, training programs that instruct item managers and contracting officers on how to perform the cost comparison analyses, and procedures requiring inventory control points to track the effectiveness of their termination decisionmaking processes. To improve termination decisions in the Navy, we recommended that the Commander, Naval Supply Systems Command: provide specific guidance to Navy contracting officers describing how to accomplish and document cost comparison analyses necessary for termination decisions, establish a $20,000 threshold for all

termination reviews, and establish performance indicators that will show the timeliness and cost-effectiveness of termination decisions. For the Air Force's termination decisionmaking process, the General Accounting Office recommended that the Secretary of the Air Force emphasize to the Commander, Air Force Logistics Command, the importance of an effective program, including appropriate management guidance and oversight, for terminating procurements of excess on-order spares when termination is in the best interest of the Government.

Actions Taken and Planned by the Services on the Audit Recommendations. The Services were responsive to the recommendations resulting from the audits. On the $36.8 million of excess on-order assets on which we and the General Accounting Office recommended termination actions, the Services terminated $29.4 million. Those terminations should have returned $18.1 million to the Services and enabled the Services to avoid interest and storage costs for retaining unneeded assets in inventory.

In response to our recommendations to improve the termination decisionmaking processes in the Army and Navy, the Army stated that the Army Materiel Command would develop the procedures and training programs necessary to make termination decisions and to evaluate the effectiveness of the termination decisionmaking process. The Navy informed us that it would develop a cost termination model for contracting officers to use in making termination decisions, establish a $20,000 threshold for semi-annual termination reviews, and develop performance standards for inventory control points to use in evaluating their termination decisionmaking processes. In response to the General Accounting Office's recommendation to improve the termination decisionmaking process in the Air Force, the Assistant Secretary of Defense (Production and Logistics) stated that his office would issue policy guidance to improve the process.

Additional Actions Required On the Part of DoD Policymakers. The actions that the Services took, and planned to take, on recommendations made during the audits should greatly improve termination decisionmaking and, as a result, reduce unnecessary expenditures. However, several actions are still needed to establish an effective termination decisionmaking process. Those needed actions are addressed in the following paragraphs.

Most urgently, the Assistant Secretary of Defense (Production and Logistics) needs to establish a DoD policy for termination decisionmaking and DoD procedures to implement that policy. The Services, in response to recommendations in our and the General Accounting Office's reports, stated that they would establish policies and procedures for termination decisionmaking. However, DoD needs to establish a policy and the procedures necessary to achieve consistent and complete implementation of the policy

among the Services and the Defense agencies. This is particularly needed due to the varying opinions on the roles of the various officials (item managers, contracting officers, administrative contracting officers, contractors, and auditors) involved in the termination decisionmaking process. For example, some managers believed that item managers should decide when it is economical to terminate a contract rather than contracting officers, as required by the Federal Acquisition Regulation. Further, some managers believe that a thorough audit by the Defense Contract Audit Agency is necessary to develop reasonable estimates of what it will cost to terminate assets from contracts. Our audits disclosed that such in-depth audits are not needed to establish reasonable estimates of termination costs, only efforts to obtain applicable production and cost data, as we will address later in this finding.

On September 8, 1987, the Assistant Secretary of Defense (Production and Logistics) released for coordination a draft DoD Instruction, "Termination of Contracts for Secondary Items That Are No Longer Needed," that proposed a DoD policy for termination decisionmaking and procedures for satisfying the policy. However, the draft DoD Instruction was never finalized and issued. Also, based on the results of our audits and the General Accounting Office's audit, the draft DoD Instruction did not contain the specificity necessary to achieve cost-effective contract termination decisions. Areas in the draft Instruction that lacked specificity are addressed in the following paragraphs.

First, the draft Instruction did not state, as part of policy, that unneeded assets on contract will be terminated from contracts when the cost to hold the assets in inventory exceeds the cost to terminate the assets from contracts. The draft Instruction required that only "considerations" be given to terminating unneeded assets from contracts. If DoD is to achieve cost-effective termination decisions, the policy statement must provide for termination decisions based on comparisons of cost factors, not subjective considerations.

Second, procedures in the draft Instruction did not specify the types of information that contracting officers should obtain and use to estimate the cost to terminate contracts. The draft Instruction only required that contracting officers "get estimated termination costs" and suggested a source and some ways of getting the costs. However, our audits disclosed that contracting officers need specific types of information to develop reasonable estimates of what it will cost to terminate contracts. As a minimum, we believe that the contracting officers need the following information:

- the total cost incurred and total financial commitments made by the contractor for on-order assets being

considered for termination. Such information, when factored with profit and administrative expenses, provides the contracting officer with the maximum possible cost of terminating the excess on-order assets from a contract.

- the number of completed units of on-order assets being considered for termination. Such information is needed to determine if the total cost incurred to date includes the cost of completed units. If so, the cost of the completed units should be deducted from total cost incurred because completed units cannot be terminated.

- the number of in-process units of on-order assets being considered for termination. This information, when combined with the quantities of units ordered and completed, will enable the contracting officer to determine how many on-order assets that the contractor has not started in production. If there are units that have not yet entered production, those units could possibly be terminated at no cost.

- the total cost incurred and financial commitments on in-process units. Such information would enable the contracting officer to estimate termination costs on in-process units.

- the number of completed units, as well as cost incurred and financial commitments on in-process units, that the contractor can transfer to other contractual efforts, thereby reducing the cost of termination to the Government.

- the number and value of orders to vendors and subcontractors that the contractor can cancel or terminate, thereby reducing its financial commitments and in turn reducing the cost of the termination to the Government.

Furthermore, contracting officers can obtain all but three types of the information described in the preceding subparagraphs by requesting from contractors the cost and pricing data shown in Item 7C, Table 15-2 of Subsection 15.804-6 of the Federal Acquisition Regulation. The three types of information that are not provided for in Item 7C of Table 15-2 are financial commitments, the amounts of costs incurred and financial commitments that can be transferred to other contracts, and the amounts of financial commitments that can be canceled or terminated. However, contracting officers can request these types of information when requesting the cost and pricing data.

Third, the draft Instruction provided for all inventory control points to establish termination coordinators to manage, monitor, and audit termination actions. However, the draft Instruction did not contain procedures specifying how the termination coordinators would perform those functions and to what extent the Services would maintain oversight of the functions. Considering

the magnitude of excess on-order assets in the Services and the high potential for termination actions, we believe that the Instruction should require the termination coordinators to develop and report various statistics to the Services. Some meaningful statistics that could be used to track compliance would be those statistics showing the number and dollar value of excess on-order assets that each inventory control point terminated, the timeliness of termination actions, and the estimated versus actual savings on termination actions. Other meaningful statistics would include the number and dollar value of excess on-order assets for which termination decisions could not be made due to the lack of contractual information and the reasons why termination actions were not appropriate on excess on-order assets with high dollar values. The Services could use those statistics to monitor the inventory control points' termination decisionmaking and act on any unfavorable trends noted in the activity.

Fourth, the draft Instruction did not specify time frames for making termination decisions. Considering the lengthy time periods that we and the General Accounting Office found the Services taking to make termination decisions, required time frames are essential to minimize termination costs.

Last, the draft Instruction did not provide for exchanges of cost information between the contracting officers that made the termination decisions and the administrative contracting officers that settle contractors' claims on terminated contracts. Such exchanges are needed for two reasons. First, contract cost information is necessary to make termination decisions and settle termination actions. Therefore, procedures should require that contracting officers who make the termination decisions provide administrative contracting officers who settle the termination decisions with the cost data that they used to make the termination decisions. Such cost data would be helpful to the administrative contracting officers in evaluating the contractors' cost claims on terminated contracts. In addition, administrative contracting officers who settle the termination decisions should be required to provide the contracting officers who made the termination decisions with negotiation memorandums showing the final settlements. Then, contracting officers would have the information necessary to assess the bases for their termination decisions.

Another benefit of the exchange of cost data between the contracting officers and the administrative contracting officers is that both parties would have data that they could use to release excess unliquidated obligations from terminated contracts.

RECOMMENDATIONS FOR CORRECTIVE ACTION

We recommend that the Assistant Secretary of Defense (Production and Logistics):

1. Revise the contract termination policy in the draft DoD Instruction, "Termination of Contracts for Secondary Items That Are No Longer Needed," to a policy requiring the Services to base termination decisions on comparisons of what it will cost to hold unneeded assets in inventory versus the cost to terminate the same unneeded assets from contracts.

2. Supplement Draft DoD Instruction "Termination of Contracts for Secondary Items That Are No Longer Needed," with procedures requiring contracting officers to obtain and use the following types of information to estimate the cost to terminate excess on-order assets from contracts:

a. Total cost incurred and other financial commitments made by the contractor.

b. Number of completed units being considered for termination.

c. Number of in-process units.

d. Total cost incurred and other financial commitments on in-process units.

e. Amounts of cost incurred and financial commitments that the contractor can transfer to other contracts.

f. Number and value of financial commitments that the contractor can cancel.

3. Specify in the Draft DoD Instruction the extent that contracting officers can obtain the information in Recommendation B.2. through requests to the contractors for cost and pricing data that are shown in Item 7C, Table 15-2, Subsection 15-804-6, "Procedural Requirements," of the Federal Acquisition Regulation.

4. Supplement the Draft DoD Instruction with procedures requiring:

a. Termination coordinators at inventory control points to monitor, act on, and report to their respective Services the number and dollar value of excess on-order assets that inventory control points terminated, the timeliness of termination actions, the estimated versus actual savings on termination actions, the number and dollar value of excess on-order assets for which termination decisions could not be made due to the lack of contractual data, and the reasons why high dollar value excess on-order assets could not be terminated from contracts.

b. The Services to monitor performance data reported by inventory control points and to act on unfavorable trends indicated by the reported data.

c. Inventory control points to make termination decisions within a prescribed number of days after the computation systems notify the item managers that assets are excess to current requirements.

d. Contracting officers to provide administrative contracting officers with the contractual cost data that they used to make termination decisions, and requiring administrative contracting officers to provide contracting officers with negotiation memorandums that show settlement costs resulting from terminations.

5. Finalize and issue the Draft DoD Instruction, "Termination of Contracts for Secondary Items That Are No Longer Needed."

MANAGEMENT COMMENTS

The Assistant Secretary of Defense (Production and Logistics) concurred "in principle" with Recommendations B.1. and B.5. and concurred "with intent" with Recommendations B.2., B.3., and B.4.a. through B.4.d. Additionally, on Recommendations B.1. and B.5., the Assistant Secretary added that his concurrence was conditionally based on the final results of the Defense Management Review's survey of DoD Issuances. He also stated that the Defense Management Review involves an intensive survey of all DoD Directives and DoD Instructions and has imposed a moratorium on new and revised issuances. On Recommendation B.2., the Assistant Secretary stated that it was not feasible to obtain from contractors the detailed information that we specified in the recommendation. On Recommendation B.3., the Assistant Secretary added that there was no need to address in the Draft DoD Instruction the extent that contracting officers should use guidance in the Federal Acquisition Regulation to obtain cost data from contractors because sufficient guidance exists in the Federal Acquisition Regulation. On Recommendations B.4.a., B.4.b., and B.4.c., the Assistant Secretary stated that the recommended actions were too detailed to be appropriate for inclusion in a DoD Instruction. The Assistant Secretary further stated that the actions should be considered by the Military Departments in their implementation of the DoD Instruction. On Recommendation B.4.d., the Assistant Secretary stated that paragraph F.5. of the Draft DoD Instruction provides sufficient information to comply with the intent of the recommendation.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Although the Assistant Secretary concurred "in principle" with Recommendations B.1. and B.5., he did not specify whether or not the recommendations would be adopted because of the ongoing Defense Management Review of DoD Directives and DoD Instructions. We ask the Assistant Secretary to specify the actions planned to carry out these recommendations and to provide the estimated completion dates of the planned actions in response to this report.

Although the Assistant Secretary concurred "with intent" of Recommendations B.2., B.3., and B.4.a. through B.4.d., he concluded that no actions were necessary on those recommendations. We disagree with his conclusions for the following reasons, and ask the Assistant Secretary to reconsider his position on the recommendations before responding to this final report. First, there is no question as to the feasibility of obtaining from contractors the types of data we listed in Recommendation B.2. We obtained those types of data from contractors in evaluating termination decisions on 77 items in our audit samples. Second, the Federal Acquisition Regulation does not contain any guidance that specifies the types of information that contracting officers should obtain from contractors for use in making termination decisions (Recommendation B.3.). Third, it would not be efficient or effective for each of the Services to establish its own guidance on oversight of its termination decisionmaking processes and the time frames in which termination decisions should be made (Recommendations B.4.a. through B.4.c.). The Services use similar processes for termination decisionmaking and as such need to monitor the same features and to establish the same time frames for making those decisions. Requiring each Service to establish its own oversight and processing timeframe requirements would be duplicative and would not ensure consistent requirements. Since our audits identified about $3.5 billion of excess on-order assets and extremely limited amounts of the assets being terminated, we believe it is imperative that DoD guidance specify oversight responsibilities and processing time frames. Last, the Draft DoD Instruction that we evaluated in our audit did not have paragraph F.5. Also, paragraph F. of the Instruction did not address the exchange of information between contracting officers as we recommended in Recommendation B.4.d. Instead, paragraph F. addressed responsibilities for termination decisionmaking. We did note that paragraph E.5. of the Draft DoD Instruction addressed procuring contracting officers obtaining the cost data necessary to make termination decisions. That paragraph, however, does not satisfy the intent of Recommendation B.4.d. As discussed in the draft report and on pages 24 and 25 of this report, the intent of Recommendation B.4.d. is to require contracting officers who make the termination decisions and those that settle the termination claims to exchange cost information so that they can facilitate and improve their efforts.

C. Government-Furnished Material

FINDING

Three inventory control points in the Army and Navy had opportunities to reduce the cost consequences resulting from uneconomical termination decisions, but they did not take advantage of such opportunities. Specifically, the inventory control points could have arranged for excess on-order assets that were not terminated and that applied to higher assemblies in production to be used as Government-furnished material on production contracts for the higher assemblies. The inventory control points did not take advantage of the opportunities due to the lack of policies and procedures requiring excess on-order assets to be used as Government-furnished material. As a result, we projected that the three inventory control points unnecessarily brought $156.9 million of excess on-order assets into inventory.

DISCUSSION OF DETAILS

Background. We visited contractors to obtain cost data necessary to evaluate the cost-effectiveness of termination decisions made by Army and Navy managers. We were able to identify cost alternatives that required consideration as part of, or subsequent to, making termination decisions. Those alternatives involved excess on-order assets that applied to higher assemblies in production being used as Government-furnished material (hereafter referred to as the GFM option) on production contracts. For example, the Army's Tank-Automotive Command had $2.5 million of excess Spur Gearshafts that was applicable to the engine for the M-1 Tank. The Spur Gearshafts were of the current configuration and were made for the Tank-Automotive Command by the same contractor that made the Spur Gearshafts for the M-1 Tank engine manufacturer. Therefore, the Tank-Automotive Command could have provided the excess Spur Gearshafts as the GFM option for the engine.

Economies in Using Excess On-Order Assets as Government-Furnished Material. The GFM option offered the Army and Navy multiple opportunities to reduce costs inherent in termination decisions. The most beneficial opportunity available under the GFM option was to use excess on-order assets as Government-furnished material when it was not economical to terminate the assets from contracts. By doing so, the Army and Navy could avoid unnecessary investments in inventory for several years and avoid the risk of excess assets in inventory becoming obsolete before being used. Additionally, the Army and Navy would avoid indirect costs and profit on production contracts because contractors would not have to make or buy assets to satisfy production contracts. Other cost-beneficial opportunities that could be obtained through the GFM option involved using the GFM option to reduce termination costs.

Our audit identified two different ways that the Army and Navy could have used the GFM option to reduce termination costs. First, the Army and Navy could have used the option for all excess on-order assets that were completed or delivered and applicable to other contracts at the time of termination action. By using the completed or delivered excess on-order assets as Government-furnished material, the Army and Navy would be able to reduce the termination costs by the total contract price of such assets. The Army and Navy would also avoid holding costs, indirect costs, and profit in the same manner as excess on-order assets that were not terminated. Second, the Army and Navy could have arranged for contractors to transfer to other contracts the work in-process on terminated excess on-order assets that is applicable to those contracts. By doing so, the Army and Navy would be able to reduce the total cost of work in-process to the cost of transferring such work to other contracts. The cost would only be a small fraction of the cost of work in-process.

Potential for Use of Excess On-Order Assets as Government-Furnished Material. To determine the extent that the Army and Navy had opportunities to use the GFM option, we performed a four-part review. We randomly selected 100 sample items at the Navy inventory control point and 53 sample items at the two Army inventory control points. We then determined which weapon systems or end items that the sample items applied to and how many units of each sample item were used on the items' applicable end item. Second, we obtained from the Army and Navy data showing the programmed and planned production for the related end items or weapon systems. Third, using the data obtained in the first two parts of our review, we calculated the number and value of sample items that potentially could be used as Government-furnished material. Finally, to determine the total potential for use of the GFM option, we statistically projected the results of our review to the value of excess on-order assets at each of the three inventory control points.

Our review disclosed that the inventory control points had the potential to use the GFM option. On the 153 items ($138.4 million) evaluated, we concluded that $30.8 million of excess on-order assets on 53 items could be used on existing or planned production contracts. Further, we statistically projected the results of our review of the 153 items to all the items with excess on-order assets at the 3 inventory control points. We concluded that the inventory control points could use $156.9 million of their excess on-order assets as Government-furnished material on production contracts.

Inventory Control Point	Projected Excess On-Order Asset That Could Be Used On Production Contracts	
	Items	Value (millions)
Army:		
Aviation Systems Command	165	$ .8
Tank-Automotive Command	176	40.3
Navy:		
Aviation Supply Office	498	115.8
Total	839	$156.9

Furthermore, we concluded that the Army and Navy could use additional excess on-order assets and excess on-hand assets as Government-furnished material if they would establish policies and procedures requiring the use of the assets as Government-furnished material when it is more cost-effective to do so than taking termination actions.

Actual Use of Excess On-Order Assets as Government-Furnished Material. Despite the high potential for using the GFM option, the Army and Navy had not taken advantage of the option. At the time of our audits, the Army and Navy had not arranged for any of the $156.9 million of excess on-order assets to be used under the GFM option. As a result, the Army and Navy unnecessarily invested that amount in inventory.

The inventory control points did not use the GFM option because DoD policy and procedure documents did not require that the GFM option be considered and applied. We identified three DoD policy documents that addressed furnishing contractors with Government-furnished material. Those documents were DoD Directive 4100.37, "Retention and Transfer of Material Assets," May 24, 1988; DoD Instruction 4140.41, "Government-Owned Material Assets Utilized as Government-furnished Material for Major Acquisition Programs," July 26, 1974; and DoD Instruction 4140.48, "Control of Access to DoD Material Inventories Required by Defense Contracts," March 6, 1986. None of those documents required item managers to use excess on-order assets as Government-furnished material when such use was more economical than other alternatives. To the contrary, the documents contained either policy statements or procedure guidance that precluded optimum use of excess on-order assets as Government-furnished material, as discussed in the following paragraphs.

Paragraph D.1. of DoD Directive 4100.37 states that it is DoD policy that DoD Components retain wholesale assets in quantities greatly in excess of the current requirements objectives. As such, excess on-order assets would seldomly be considered for use as Government-furnished material.

Paragraph I of DoD Instruction 4140.41 advocates "... optimum economic utilization of available Government-owned materiel assets as Government-furnished materiel (GFM) in lieu of Contractor Furnished Materiel (CFM) in production contracts for major systems and equipment." However, the DoD Instruction does not contain procedures to achieve optimum use. Paragraph II of the DoD Instruction specifies that only "the major hardware acquisition organizations" were responsible for identifying potential opportunities to use Government-owned assets as Government-furnished material. Since those organizations are not aware of which assets are excess to the inventory control points' needs, optimum use can not be achieved. Also, the DoD Instruction does not specify how to quantify unneeded assets. It makes reference to "long supply assets" but does not define such assets.

Paragraph F.3. of DoD Instruction 4140.48 states that Government-owned assets in excess of the "Approved Force Acquisition Objective" shall be considered for use as Government-furnished material. However, the "Approved Force Acquisition Objective" is so much greater than the requirements objective that excess on-order assets would seldomly be considered for use as Government-furnished material.

Actions Recommended to Management During the Audits. To achieve optimum use of excess on-order assets at the three inventory points included in the audits, we recommended that the Army and Navy establish policies and procedures requiring that their inventory control points use excess on-order assets as Government-furnished material on production contracts.

Actions Taken By Management on Audit Recommendations. The Army and Navy concurred with our recommendations to establish policies and procedures on the use of excess on-order assets as Government-furnished material. The Army stated that its Deputy Chief of Staff for Logistics would establish such policies and procedures. The Navy stated that it had established a "flag level steering group" that would assess the cost-effectiveness of using excess on-order and excess on-hand assets as Government-furnished material.

Additional Actions Required By Management. The actions taken and planned by the Army and Navy should prove cost-beneficial. However, additional actions are required if DoD is to realize the optimum benefits of the GFM option. Specifically, the Assistant Secretary of Defense (Production and Logistics) needs to revise the DoD Directive and the two DoD Instructions that provide policy and procedures for furnishing Government material to contractors so that inventory control points must use the GFM option when it is economical. Further, to decide when it is economical to use the GFM option, the Assistant Secretary needs to establish procedures that require inventory control points to calculate and include the cost of the GFM option as a part of the economic analyses that they should make in deciding

whether or not to terminate unneeded assets from contracts. We believe that procedural requirements should be incorporated into the draft DoD Instruction, "Termination of Contracts for Secondary Items That Are No Longer Needed," that we addressed in our recommendations in Finding B. Finally, the Assistant Secretary needs to establish procedures requiring inventory control points to report data to their respective Services showing the extent that they used the GFM option and explaining why the GFM option could not be used on high dollar value assets. Those procedures should also require that the Services monitor their inventory control points' uses and non-use of the GFM option.

RECOMMENDATIONS FOR CORRECTIVE ACTION

We recommend that the Assistant Secretary of Defense (Production and Logistics):

1. Revise the retention policy specified in Paragraph D.1. of DoD Directive 4100.37, "Retention and Transfer of Material Assets," to require the Services to use, as Government-furnished material, on-order assets that are beyond the requirements objective and that cannot be terminated from contracts.

2. Supplement Paragraph II of DoD Instruction 4140.41, "Government-Owned Material Assets Utilized as Government-furnished Material for Major Acquisition Programs," to include the responsibilities for inventory control points to identify on-order assets that are beyond requirements objectives, that cannot be terminated from contracts economically, and that are applicable to items in production. Inventory control points should also arrange for such assets, as well as similar on-hand assets, to be used as Government-furnished material on production contracts.

3. Revise Paragraph F.3. in DoD Instruction 4140.48, "Control of Access to DoD Material Inventories Required by Defense Contractors," to require the Services to provide to contractors, as Government-furnished material, on-order assets that are beyond the requirements objective and that cannot be terminated from contracts economically.

4. Supplement Draft DoD Instruction, "Termination of Contracts for Secondary Items That Are No Longer Needed," with requirements for:

a. Inventory control points to:

(1) Calculate and include the cost of the Government-furnished material option as a part of economic analyses that they make when deciding whether or not to terminate from contracts excess on-order assets that are applicable to items in production. If the cost of the Government-furnished material option is the most cost favorable of three options

(terminate, do not terminate, or use as Government-furnished material), require a written justification when that option is not exercised.

(2) Report the extent that excess on-order assets that cannot be terminated due to economical reasons are applicable to higher assemblies that are in production, and the extent that such assets were used as Government-furnished material on the production contracts. Also, the reporting should include explanations for not using applicable excess on-order assets valued over a prescribed dollar value.

b. The Services to monitor reports from inventory control points on the use and non-use of excess on-order assets as Government-furnished material.

MANAGEMENT COMMENTS

The Assistant Secretary of Defense (Production and Logistics) concurred "with intent" of Recommendations C.1. through C.4. Additionally, on Recommendations C.1. through C.3., the Assistant Secretary stated that GFM requirements, when known, are included in total requirement computations and as such were already considered when making termination decisions. On Recommendation C.4., the Assistant Secretary added that ". . . implementation beyond the specific inclusion of the GFM option in F.6. of the Draft DoD Instruction is not practical due to the high costs of collecting such data."

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Although the Assistant Secretary concurred "with intent" of the recommendations, he concluded that no actions were necessary on the recommendations. We disagree with the Assistant Secretary's conclusions for the following reasons. First, inventory control points neither included GFM requirements in requirement computations nor considered them in termination decisions (Recommendations C.1. through C.3.). As stated in a draft of this report and on pages 33 and 34 of this report, the primary reason that the GFM option was not considered was an absence of such a requirement in the DoD Instructions and DoD Directive. Second, our audit did not identify any costs that would make it prohibitive or impractical for the Services to report and track the extent that they used and did not use the GFM option (Recommendation C.4.).

We ask the Assistant Secretary to reconsider his conclusions before responding to this final report.

EXECUTIVE SUMMARIES FROM AUDIT REPORTS USED TO PREPARE THIS FINAL SUMMARY REPORT

Executive Summary of Audit Report	See This Appendix Page
Office of the Inspector General, DoD, Report No. 89-063, "Contract Terminations at Army Inventory Control Points," March 29, 1989	2
Office of the Inspector General, DoD, Report No. 88-153, "Contract Terminations at the Navy Aviation Supply Office," May 23, 1988	7
General Accounting Office, Report No. GAO/ NSIAD-87-141 (OSD Case No. 7242), "Military Procurement: Air Force Should Terminate More Contracts for On-Order Excess Spare Parts," August 12, 1987	12

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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March 29, 1989

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)

SUBJECT: Report on the Audit of Contract Terminations at Army Inventory Control Points (Report No. 89-063)

This is our final report on the Audit of Contract Terminations at Army Inventory Control Points for your information and use. The audit was made from November 1987 through August 1988. The objectives of the audit were to determine the cost-effectiveness of termination decisions made by officials at the Army's inventory control points, the completeness of documentation supporting those termination decisions, and the effectiveness of internal controls over the inventory control points' entire termination decisionmaking processes. As of September 30, 1987, the Army reported $7.1 billion of spare parts as due-in from contractors and $881.8 million of those parts as excess to the Army's needs (excess on-order assets). Our audit included random tests of $396.8 million of excess on-order assets at two of the Army's six inventory control points: the Aviation Systems Command and the Tank-Automotive Command (the Commands).

The Army did not have an effective process for making economical contract termination decisions, and the quality of documentation supporting termination decisions and internal controls over the termination decisionmaking process needed improvement. Furthermore, the Army will not be able to establish an effective, efficient termination decisionmaking process until it can accurately quantify the value of excess assets on contracts. The Army initiated procedures during the audit to require that termination decisions be based on a comparison of the cost to terminate versus the cost to hold. The Army also promptly initiated action to terminate contracts and use excess on-order assets as Government-furnished material when the audit identified cost-beneficial situations. The Army's actions to improve contract termination procedures and reduce costs solved some problems. However, further improvements are needed. The conditions requiring improvements are summarized in the following paragraphs, and the details, audit recommendations, and management comments are in Part II of the report.

Item managers and contracting officers made uneconomical termination decisions on 51 percent of the sample items evaluated in the audit. In dollar value, we projected that the Commands made termination decisions on $243.1 million of excess on-order

assets, and the decisions on $100.2 million of those assets were not cost-effective. Further, we projected that the Commands could incur as much as $87.3 million per year of unnecessary investment, interest, and storage costs as a result of uneconomical termination decisions. To improve termination decisions, we recommended that the Commander, Army Materiel Command, establish detailed procedures for performing cost comparison calculations for termination decisions and establish training programs necessary to implement the procedures. We also recommended that the Commander, Army Materiel Command, establish and use performance indicators to evaluate the effectiveness of the termination decisionmaking process. To reduce the unnecessary costs that the Army could incur as a result of uneconomical termination decisions, we recommended that Assistant Secretary of the Army (Installations and Logistics) take immediate action to transfer, as Government-furnished material to production contracts that will be awarded in fiscal year 1989, excess on-order assets that were not terminated as a result of uneconomical decisions. We also recommended that the Assistant Secretary establish policies and procedures requiring such transfers in subsequent fiscal years (page 5).

The value of excess on-order assets in the Army was overstated by a projected $331.7 million (38.7 percent). Until the Army can accurately quantify the value of its excess on-order assets, it will not be able to establish an effective, efficient termination decisionmaking process. To achieve an accurate value of excess on-order assets, we recommended that the Commander, Army Materiel Command, establish additional controls over the item managers' validations of excess on-order asset positions and verify the accuracy of final excess on-order asset positions (page 17).

The audit also identified material internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. One weakness was the absence of controls over the completeness and timeliness of item managers' validations and contracting officers' termination decisions. Another weakness was a lack of procedures specifying how to make termination decisions; requiring managers to use, as Government-furnished material, excess on-order assets not terminated from contracts; and requiring verification of the values of final excess on-order assets positions. Recommendations A.1., A.2., and B. in this report, if implemented, will correct the weaknesses and should greatly improve the controls over the termination process. A copy of this report is being provided to the senior officials who are responsible for internal control within the Army.

On November 17, 1988, we provided a draft of this report to the Assistant Secretary of the Army (Financial Management) for review and comments. On February 28, 1989, we received comments

from the Director of Supply and Maintenance in the Office of the Army's Deputy Chief of Staff for Logistics. A complete text of management's comments is included in Appendix M.

Management's comments to the draft of this report did not fully comply with the requirements of DoD Directive 7650.3. The Director of Supply and Maintenance concurred with all the findings and recommendations and described actions that the Army took and planned to take on the recommendations. However, the Director did not provide estimated dates for completion of planned actions on Recommendations A.1.a., A.1.b., A.2.b., A.2.c., A.2.d., and B. Also, the Director's description of actions planned for Recommendation B. was not clear. The recommendation provided for the Army Materiel Command to establish procedures requiring that Army inventory control points establish the controls necessary to achieve accurate excess on-order asset positions before making termination decisions. In response to the recommendation, the Director referred to certain "internal control requirements," but it was not clear what requirements he was referring to and how those requirements would satisfy the recommendation. We ask that you provide completion dates for the six recommendations that we specified above and clarify comments on Recommendation B. when responding to this final report.

The Director did not specifically comment on internal control weaknesses identified in the draft report. However, his concurrence with the findings and recommendations in the draft report will result in the needed changes to internal controls. Therefore, additional management comments are not needed on the internal control weaknesses.

The Director also did not provide comments on the potential monetary benefits of the recommendations in the draft report. The draft report claimed $493.8 million of potential monetary benefits from fiscal years 1989 through 1993. In his response to the draft report, the Director stated that the Army was still analyzing the claimed monetary benefits and that the analyses would be completed on March 15, 1989. However, we had not received the comments at the time we issued this report.

Although we did not receive the Army's comments on the potential monetary benefits claimed in the draft report, we have revised our statistical projections of the potential monetary benefits of the recommendations. We revised the projections because the Army showed us that requirements for one item in our audit had increased to the extent that there were no excess assets to be used as Government-furnished material on production contracts. Based on our revised projections, we are claiming $483.3 million of potential monetary benefits from fiscal years 1989 through 1993. The $483.3 million includes $89.5 million of potential monetary benefits that can be realized in each of the

5 years if the Army establishes an effective termination decisionmaking process and establishes a process for using, as Government-furnished material, excess on-order assets that the termination decisionmaking process had determined to be uneconomical to terminate (page 1 of Appendix L). The other $35.8 million of potential monetary benefits is a one-time benefit that can be realized from fiscal years 1989 through 1991 if the Army uses excess on-order assets that were not terminated in June and September 1987 as Government-furnished material on production contracts (page 2 of Appendix L).

It is significant to understand that the $483.3 million of potential monetary benefits represents only a portion of the monetary benefits that the Army can realize by implementing the recommendations in this report. The $483.3 million represents only the benefits that can be realized at the Commands included in this audit. Since the Commands were randomly selected from the Army's six inventory control points, we believe that our audit results are representative of the situations at the other four inventory control points. Based on our statistical projections at the Commands, we have an indication that the Army could realize an additional $570.4 million of potential monetary benefits at the other four inventory control points. The $570.4 million includes $103.7 million that can be realized in each of the 5 years between fiscal years 1989 and 1993 if the Army establishes processes for making cost-effective termination decisions and uses excess on-order assets as Government-furnished material on production contracts (footnote 4 on page 1 of Appendix L). The other $51.9 million of potential monetary benefits is a one-time benefit that can be realized from fiscal years 1989 through 1991 by the four inventory control points using excess on-order assets, as of September 1987, that were not terminated as Government-furnished material on production contracts (footnote 8 on page 2 of Appendix L). We are not claiming any potential monetary benefits for the four inventory control points in this report.

DoD Directive 7650.3 requires that all audit recommendations be resolved within 6 months of the date of the final report. Accordingly, we ask that you provide the completion dates for planned and in-process actions and clarify comments on Recommendation B. within 60 days of the date of this memorandum. We ask that you also provide comments within 60 days on the $483.3 million of potential monetary benefits claimed in the report. In order for your comments on the potential monetary benefits to be considered responsive, you must state concurrence or nonconcurrence with the amount of benefits claimed in the report. If you nonconcur with the estimated potential monetary benefits or any part thereof, you must state the amount you nonconcur with and the basis for your nonconcurrence. Potential monetary benefits are subject to resolution 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. David K. Steensma, Program Director, on 202-693-0186 (AUTOVON 223-0186) or Mr. Rayburn H. Stricklin, Project Manager, on 202-693-0392 (AUTOVON 223-0392). Copies of this final report are being provided to the activities listed in Appendix O.

Stephen A. Trodden
Assistant Inspector General
for Auditing

Enclosures

cc:
Secretary of the Army
Assistant Secretary of Defense
(Production and Logistics)

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May 23, 1988

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)

SUBJECT: Report on the Audit of Contract Terminations at the Navy Aviation Supply Office (Report No. 88-153)

This is our final report on the Audit of Contract Terminations at the Navy Aviation Supply Office. The audit was made from December 1986 through June 1987. The overall audit objective was to determine how well the Aviation Supply Office identified unneeded assets on contracts and terminated those assets when it was in the Government's best interest. The audit included random tests of $712.8 million of excess on-order assets identified by the Aviation Supply Office's automated requirements system. Of the $712.8 million initially identified by the automated system, we projected that about $528.4 million was excess on-order assets based on reviews by item managers and our audit.

The Aviation Supply Office used a three-part process to identify and terminate unneeded assets. First, an automated system at the Aviation Supply Office provided item managers with lists of excess on-order assets based on the latest requirement and asset data. Second, item managers reviewed the excess items on the lists to determine the accuracy of the data used by the automated system in computing the excesses and, in doing so, determined whether or not the items were excess to the Aviation Supply Office's needs. Finally, item managers requested contracting officers in the Purchasing Directorate to terminate any excess on-order items if it was in the Government's best interest.

Management has initiated actions to improve problems that this audit found in the termination decisionmaking process. On April 20, 1987, the Director of Operations at the Navy Aviation Supply Office established a policy that should result in more excess on-order assets being identified for termination considerations. On September 8, 1987, the Assistant Secretary of Defense for Production and Logistics proposed a DoD instruction that, if adopted, will establish policy and fix responsibilities for terminating excess on-order assets. Finally, on February 16, 1988, the Commander of the Navy Aviation Supply Office identified $141.9 million of excess assets as potential candidates for use as Government-furnished material on production contracts. Use of the excess assets as Government-furnished material will enable the Navy to realize annual recurring savings.

Overall, we concluded that the Aviation Supply Office did not have an effective process for identifying and terminating excess assets on contracts. Specifically, we projected that about 38 percent of the excess on-order assets either was not identified or considered for termination. We also projected that almost 46 percent of the excess on-order assets considered for termination was not terminated although termination actions would have been cost-effective. These problems are discussed in the following paragraphs, and the details, together with audit recommendations, are contained in Part II of the report.

Item managers' validations of data used by the automated system in computing excess on-order assets were inaccurate and incomplete. We projected that item managers, in validating $415.6 million of excess on-order assets, neither identified nor considered $88.6 million of excess on-order assets for termination. As a result, DoD could incur as much as $39.8 million of unnecessary investment and storage costs each year on unidentified excess on-order assets that could have been terminated. To improve the quality of item managers' validations, we recommended additional validation procedures, training programs for item managers and their supervisors, and critical elements in item managers' and their supervisors' performance plans covering validations of excess on-order assets (page 5).

Item managers and contracting officers made uneconomical termination decisions. On $142.8 million of excess on-order assets, we projected that they decided not to terminate $65.1 million of the assets although termination actions would have been cost-effective. As a result, DoD could incur annually $19.2 million of unnecessary investment and storage costs. In addition, we projected that officials did not consider $112.8 million of other excess on-order assets for termination reviews. As a result, DoD could incur annually $16.2 million of unnecessary costs on excess on-order assets that should have been terminated. To improve termination decisions, we recommended that management establish procedures that explain how contracting officers decide when termination action is appropriate and establish performance indicators that will show the effectiveness of the termination decisionmaking process. To ensure that excess on-order assets receive sufficient termination considerations, we recommended that management establish a $20,000 threshold for all termination reviews and make provisions for the increased work load that will result from the threshold. Additionally, to avoid the unnecessary costs that DoD could incur as a result of problems in the termination process, we recommended that management transfer existing excess on-order and on-hand assets as Government-furnished material to production contracts when possible. In total, as much as $115.8 million of excess on-order assets and $19.1 million of excess on-hand assets could be transferred to production contracts, thereby reducing inventory investment and holding costs (page 15).

On January 19, 1988, a draft of this report was provided to the Assistant Secretary of the Navy (Financial Management). Comments received from the Assistant Secretary of the Navy (Shipbuilding and Logistics) were dated April 18, 1988. A complete text of management's comments is included in Appendix J.

The Assistant Secretary concurred with all recommendations in Finding A and stated that the Navy would complete actions on the recommendations by October 30, 1988. Accordingly, no additional management comments are required on those recommendations. The Assistant Secretary concurred with Recommendation B.1.a., which provided for the Navy to establish a policy requiring it to use excess assets as Government-furnished material on production contracts, but he did not address whether or not a policy would be established and if so when the policy would be established. The Assistant Secretary also concurred with Recommendations B.2.a. and B.2.c., but did not specify the dates when planned actions would be completed. On Recommendations B.1.b. and B.2.b., the Assistant Secretary nonconcurred, but proposed alternative actions that were responsive to the intent of the recommendations. For the final report, we revised Recommendations B.1.b. and B.2.b. We ask that management provide final comments, including estimated or actual completion dates, on each of the five recommendations in Finding B.

The Assistant Secretary of the Navy (Shipbuilding and Logistics) nonconcurred with both findings in our draft report. The main areas of disagreement concerned the accuracy of data presented in the findings and the manner in which we presented the cost consequences of conditions found during the audit. We believe the data shown in the findings are accurate and have described our reasons in Part II of the report. We revised the manner in which we presented the cost consequences of each finding. We ask that the Navy review our reasons for maintaining that the data in the finding are accurate, as well as our revisions to cost consequences, and provide final comments on the findings.

The Assistant Secretary also disagreed with the amount of potential monetary benefits of the recommendations in the draft report. The draft report claimed $273.4 million of savings. The Assistant Secretary agreed with $49 million of the savings. Based on the Assistant Secretary's comments, we revised the estimated dollar savings to $184.6 million. The following table shows a breakout of the savings claimed in the draft report, the Navy's position on those savings, and the revised estimate of the savings shown in this report.

Method of Savings	Savings ($ million) Draft Report	Navy	Final Report
1. Use Excess Assets as Government-Furnished Material on Production Contracts	$216.0	$25.0	$134.9
2. Identify Excess On-Order Assets for Termination Considerations	19.9	12.0	19.9
3. Make Cost-Effective Termination Decisions	9.6	9.6	9.6
4. Expand the Scope of Termination Reviews	10.5	0	8.1
5. Reduce Unnecessary Inventory Investment	17.4	2.4	12.1
Total	$273.4	$49.0	$184.6

The bases for our revised estimate are described briefly here and in more detail in Part II of this report. We revised the savings shown for the use of excess assets as Government-furnished material because the higher assemblies on which the assets would be used either were no longer in production or there was not sufficient time available before the start of production to place the assets at contractors' plants. We did not revise the $19.9 million of savings estimated for identifying excess on-order assets for termination considerations because we considered the estimate valid. We reduced the estimated savings for expanded termination reviews to show the savings achievable under a $20,000 termination review threshold rather than the $5,000 threshold that we used for the audit. Finally, we reduced interest savings on reduced inventory investments as a result of other reductions in savings.

The $184.6 million of savings claimed in this report consists of a one-time savings of $134.9 million and a recurring annual savings of $49.7 million, as shown on Appendix H. The $134.9 million one-time savings is achievable from fiscal years 1989 through 1994 by using excess assets as Government-furnished material on production contracts. The annual recurring savings consists of $37.6 million of savings that can be realized by establishing an effective termination decisionmaking process and $12.1 million of interest savings that can be realized by reducing investments in excess inventory. We ask that management provide final comments on the $184.6 million of savings.

DoD Directive 7650.3 requires that all audit recommendations be resolved within 6 months of the date of the final report. In order to satisfy that requirement, we ask that you provide your final position on each recommendation and the potential monetary benefits within 60 days of the date of this report. In order for your comments to be considered responsive, you must state

concurrence or nonconcurrence with the recommendations and savings. If you nonconcur with the recommendations or savings, you must state the reason you nonconcur and the basis for your nonconcurrence.

A copy of this report is being provided to the senior officials who are responsible for internal controls because the audit identified material internal control deficiencies as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. The deficiencies included the absences of quality checks or supervisory reviews of item managers' validations of excess on-order assets, lack of controls over the timeliness of item managers' validations and contracting officers' termination decisions, insufficient controls to prevent lost "Request for Termination" forms, the absence of procedures that specify how to make cost-effective termination decisions, and insufficient controls to ensure that validations and termination decisions are made on all excess on-order assets valued at $20,000 or more. Additionally, the termination process lacked documentation. Proper implementation of Recommendations A.1., B.2.c., B.2.a., and B.2.b. in this report should greatly improve the controls over the termination process.

Copies of the final report are also being distributed to the activities shown in Appendix L.

The courtesies and cooperation extended to the audit staff are appreciated. If you have any questions regarding this report, please contact Mr. David K. Steensma, Program Director, at (202) 693-0186 or AUTOVON 223-0186 or Mr. Rayburn H. Stricklin, Project Manager, at (202) 693-0392 or AUTOVON 223-0392.

Richard W. Townley

Richard W. Townley
Deputy Assistant Inspector General
for Auditing

Enclosure

cc:
Assistant Secretary of Defense (Production and Logistics)
Deputy Assistant Secretary of Defense (Administration)
Secretary of the Navy
Assistant Secretary of the Navy (Shipbuilding and Logistics)
Comptroller of the Navy
Commander, Naval Supply Systems Command
Commander, Aviation Supply Office

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-225030

August 12, 1987

The Honorable Bill Chappell, Jr.
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

The Honorable William V. Roth
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

As requested, we are reporting the results of our review of Air Force procedures and practices for terminating procurements of excess on-order[1] recoverable aircraft spare parts.[2] The objective of our review was to determine whether the Air Force Logistics Command (AFLC) adequately considers the cost effectiveness of terminating contracts for excess on-order material. Our review covered two of the Air Force's five air logistics centers (ALCs)—Sacramento and San Antonio. We found that terminations should be increased, thereby reducing the government's procurement and inventory holding costs and providing the basis for reduced spares funding requests by the Air Force.

We reviewed 44 of 70 items at the two ALCs having September 30, 1985, on-order values which included more than $1 million that was excess to needs. The on-order excess values for the 44 items totaled $74.2 million and those for the 70 items totaled $103.2 million. We found that the ALCs had terminated the procurement of only $1.8 million, or less than 3 percent of the sample we reviewed. Our analyses showed that they should have terminated an estimated additional $24.9 million, about 24 percent, of the $103.2 million universe.

The ALCs had not terminated these procurements because the cost benefits to be derived were not adequately and promptly analyzed. Had they terminated the procurements, the government would have saved between about $11.9 million and $36.8 million, depending on whether some or all of the material had to be reprocured. The $11.9 million, which assumes the material would be reprocured, represents the difference between the inventory holding costs that would be avoided and the contract termination costs that would be incurred. The $36.8 million,

[1]Excess on-order spare parts are those quantities that exceed a 4-year supply

[2]Recoverable spare parts are those which can be repaired and reused after becoming unserviceable

which assumes that the material would not be reprocured, includes the $11.9 million plus the $24.9 million value of the items.

ALC officials agreed to reconsider their earlier decisions. By the time we completed our fieldwork, they had terminated procurements of about $10.5 million of the $24.9 million on-order excesses that our analyses showed should have been terminated and were considering others. Estimated net savings from these actions are between $5.2 million and $15.7 million, depending on whether future reprocurement of some or all of the material is necessary.

We also found that the Air Force's automated D041 system, which generates tentative termination recommendations for managers, contains highly inaccurate data, thus making its recommendations unreliable.

We briefed AFLC officials on our findings and conclusions and they agreed that the termination process at all ALCs should be improved. Based on the missed opportunities to terminate procurements for excess on-order material we identified at the two ALCs, we believe that improving the management controls of the termination process at all ALCs could significantly reduce the government's procurement outlays and inventory holding costs. Such improvement could also enable the Air Force to reduce its future aircraft procurement appropriation requests.

The objectives, scope, and methodology of our review are described in appendix I.

EXCESS ON-ORDER ASSETS AT THE SERVICES' INVENTORY CONTROL POINTS AND AT INVENTORY CONTROL POINTS SELECTED FOR AUDIT

Inventory Control Points	Line Items With Excess On-Order Assets			
	All Inventory Control Points 1/		Inventory Control Points Selected For Audit	
	Items	Value (millions)	Items	Value (millions)
Army:				
Armament, Munitions and Chemical Command	3,646	$ 200.3		
Aviation Systems Command	7,775	240.8	7,775	$ 240.8
Communications-Electronics Command	6,387	105.6		
Missile Command	4,377	104.6		
Tank-Automotive Command	3,773	167.4	3,773	167.4
Troop Support Command	1,748	63.1		
Navy:				
Aviation Supply Office	5,022	712.8	5,022	712.8
Ships Parts Control Center	6,354	273.2		
Air Force:				
Ogden Air Logistics Center	691	200.0		
Oklahoma City Air Logistics Center	1,167	274.9		
Sacramento Air Logistics Center	886	88.1	886	88.1
San Antonio Air Logistics Center	1,271	599.7	1,271	599.7
Warner Robins Air Logistics Center	1,461	461.8		
Total	44,558	$3,492.3	18,727	$1,808.8

1/ The number of items and values shown under this heading were based on data as of September 30, 1987, for all Army inventory control points except the Aviation Systems Command. The as of date of data shown for the Aviation System Command was June 30, 1987. For Navy and Air Force inventory control points, the as of dates of the data were September 30, 1986, and September 30, 1985, respectively.

SAMPLING METHODOLOGY

Army Inventory Control Points. We used a stratified statistical cluster sampling method to select samples at the two Army inventory control points included in the audits. In doing so, we obtained lists of 11,548 line items on which the Aviation Systems Command and the Tank-Automotive Command reported having $408.2 million of excess on-order assets. We stratified the line items on the lists into five strata: line items valued over $10 million, from $1 million to $10 million, from $100,000 to $1 million, from $5,000 to $100,000, and less than $5,000. Then, for each of the four strata that had items valued at $5,000 or more, we randomly selected line items for audit evaluation. At the Aviation Systems Command, we randomly selected 100 items, valued at $109.2 million, from a list of 2,956 items, valued at $234.8 million, that the automated requirements computation systems and item managers identified as having excess on-order assets as of June 30, 1987. Similarly, at the Tank-Automotive Command, we randomly selected 100 items, valued at $117.9 million, from the 718 items, valued at $161.9 million, that the automated requirements computation systems and item managers identified as having excess on-order assets as of September 30, 1987. After reviewing item managers' validations on the 200 randomly selected items, we randomly selected subsamples from the sample items that had valid excess on-order assets and used the subsample items to evaluate the inventory control points' termination decisions. At the Aviation Systems Command, we selected 26 items, valued at $23.2 million, for our subsample. At the Tank-Automotive Command, our subsample consisted of 27 items that had $24.1 million of excess on-order assets. On pages 3 and 4 of this Appendix, we provide schedules showing, by strata, the number of line items with excess on-order assets at the two inventory control points, the values of those assets, and the number and value of line items selected for review.

Navy Inventory Control Point. We also used a stratified cluster sampling method to select a sample of line items with excess on-order assets at the Aviation Supply Office as of September 30, 1986. We stratified line items with excess on-order assets into the following strata: line items valued over $1 million, $500,000 to $1 million, $170,700 to $500,000, $5,000 to $170,700, and less than $5,000. Then, for each of the four strata that had items valued at $5,000 or more, we randomly selected line items for audit evaluation. In total, we randomly selected 100 items, valued at $91 million, from the list of 5,022 items, valued at $712.8 million, that the Aviation Supply Office's automated requirements computation system identified as excess on-order assets as of September 30, 1986. On page 5 of this Appendix, we provide a schedule showing, by strata, the number of line items with excess on-order assets at the Aviation Supply Office, the values of those assets, and the number and value of line items selected for review.

Air Force Inventory Control Points. The General Accounting Office used the following steps to select its samples at the Sacramento and San Antonio Air Logistics Centers. Its auditors obtained computer printout listings that showed recommended termination quantities for recoverable items managed by the Sacramento and San Antonio Air Logistics Centers for the September 1985 requirements computation cycle, the most recent quarter for which data were available at the start of the review. The auditors analyzed the printouts and identified a universe of items with termination values of $1 million or more for detailed review. They selected a threshold of $1 million or more because of the large number of items in the universe, the wide distribution of dollar values, and the audit time that would have been required for a complete review of all the requirements computation cycle termination actions for September 1985. The audit universe consisted of 70 items with recommended excess on-order terminations, valued at $537.4 million (19 items valued at $30.7 million at the Sacramento Air Logistics Center and 51 items valued at $506.7 million at the San Antonio Air Logistics Center). The sample consisted of 44 items with recommended excess on-order terminations valued at $441.9 million. The General Accounting Office selected all 19 items at Sacramento and randomly selected 25 of the 51 items at San Antonio.

SAMPLING METHODOLOGY (Continued)

Line Items With Excess On-Order Assets Selected For Audit

Aviation Systems Command as of June 30, 1987

Value of Line Items	Line Items with Excess On-Order Assets		Line Items Selected for Audit			
			Initial Sample		Subsample	
	Items	Value ($000)	Items	Value ($000)	Items	Value ($000)
Over $10 million	2	$ 28,404.4	2	$ 28,404.4	1	$ 2,231.8
$1 million to $10 million	21	66,521.5	21	66,521.5	7	18,490.3
$100,000 to $1 million	295	75,845.8	47	13,527.9	9	2,334.9
$5,000 to $100,000	2,638	64,067.8	30	736.9	9	189.4
Subtotal	2,956	$234,839.5	100	$109,190.7	26	$23,246.4
Less than $5,000 1/	4,819	5,929.9	0	0.0	0	0.0
Total	7,775	$240,769.4	100	$109,190.7	26	$23,246.4

1/ Excesses with total dollar values less than $5,000 were not reviewed during the audit.

SAMPLING METHODOLOGY (Continued)

Line Items With Excess On-Order Assets Selected For Audit

Tank-Automotive Command as of September 30, 1987

Value of Line Items	Line Items with Excess On-Order Assets		Line Items Selected for Audit			
			Initial Sample		Subsample	
	Items	Value ($000)	Items	Value ($000)	Items	Value ($000)
Over $10 million	1	$ 26,003.7	1	$ 26,003.7	0	$ 0
$1 million to $10 million	29	77,408.5	29	77,408.5	8	20,853.8
$100,000 to $1 million	146	41,865.8	45	13,568.1	13	3,025.9
$5,000 to $100,000	542	16,652.2	25	927.5	6	214.6
Subtotal	718	$161,930.2	100	$117,907.8	27	$24,094.3
Less than $5,000 2/	3,055	5,465.8	0	0.0	0	0.0
Total	3,773	$167,396.0	100	$117,907.8	27	$24,094.3

2/ Excesses with total dollar values less than $5,000 were not reviewed during the audit.

SAMPLING METHODOLOGY (Continued)

Line Items With Excess On-Order Assets Selected for Audit

Aviation Supply Office as of September 30, 1986

Value of Line Items	Line Items With Excess On-Order Assets		Line Items Selected for Audit	
	Items	Value ($000)	Items	Value ($000)
Over $1 million	101	$351,344.0	25	$69,246.2
$500,000 to $1 million	132	93,574.0	25	18,501.7
$170,700 to $500,000	411	114,234.4	4	1,083.3
Subtotal	644	$559,152.4	54	$88,831.2
$5,000 to $170,700 3/	3,671	151,716.5	46	2,203.8
Less than $5,000 4/	707	1,980.6	0	0.0
Total	5,022	$712,849.5	100	$91,035.0

3/ Items with extended values below $170,700 are shown eparately because the Aviation Supply Office did not require item managers to review items below that dollar threshold for the review cycle that ended September 30, 1986.

4/ Excesses with total dollar values less than $5,000 were not reviewed during our audit.

SYNOPSES OF PRIOR AUDIT REPORTS ON CONTRACT TERMINATIONS

Report No. 89-063, "Contract Terminations at Army Inventory Control Points," March 29, 1989. This report stated that the Army did not have an effective process for making economical contract termination decisions. Also, the quality of documentation supporting termination decisions, as well as internal controls over the termination decisionmaking process, needed improvement. Furthermore, the report stated that the Army will not be able to establish an effective and efficient termination decisionmaking process until it can accurately quantify the value of excess on-order assets. To improve the termination decisionmaking process, the report recommended that the Army establish procedures that specify how to make cost-effective termination decisions, how to use training programs to implement the procedures, and what performance indicators to use to assess compliance with the procedures. To improve the accuracy of excess on-order asset values, the report recommended that the Army establish additional controls over item managers' validations of excess on-order asset positions. Further, to reduce the unnecessary costs that the audit determined the Army would incur as a result of past uneconomical termination decisions, the report recommended that the Army take immediate action to transfer, when possible, excess on-order assets that were not terminated to production contracts as Government-furnished material. The report also recommended that the Army establish a policy and procedures for such transfers in the future. The Director of Supply and Maintenance in the Office of the Army's Deputy Chief of Staff for Logistics agreed to act on all the recommendations in the report.

Report No. 89-040, "Quick-Reaction Report on the Audit of Contract Terminations at the Tank-Automotive Command," December 14, 1988. The report stated that $9.2 million of unneeded spare parts due-in on nine Tank-Automotive Command contracts and delivery orders could be terminated with little or no cost to the Government or used as Government-furnished material. The report recommended that the Commander, Tank-Automotive Command, recompute requirements for the parts and initiate appropriate action to terminate unneeded spare parts or to use them as Government-furnished material. The report stated that the Army could save about $6.7 million by adopting the recommendation. Management comments were received from the Director of Supply Maintenance in the Office of the Army's Deputy Chief of Staff for Logistics. The Director stated that the Army agreed that actions were needed on the $9.2 million of unneeded assets. He also stated that management actions had achieved $3.9 million of savings and that by May 31, 1989, the Army would decide whether an additional $2.8 million of savings was possible.

Report No. 89-004, "Quick-Reaction Report on the Audit of Contract Terminations at Army Inventory Control Points," October 13, 1988. The report stated that requirement and cost factors indicated that $4.6 million of unneeded spare parts due-in on eight delivery orders of the Aviation Systems Command could be either terminated, used as Government-furnished material on Apache helicopters, or used to offset existing and planned repair programs. The report recommended that the Commander, Aviation Systems Command, verify the cost factors and initiate appropriate action to terminate unneeded parts or to use them as Government-furnished material on Apache helicopters or as offsets to existing and planned repair programs. The report stated that the Army could save $4.1 million by adopting the recommendation. Management comments were received from the Director of Supply and Maintenance in the Office of the Army's Deputy Chief of Staff for Logistics. The Director stated that the Army had saved $1.4 million by acting on the recommendation, and was taking actions to determine whether an additional $.2 million of savings was possible. The Director added that the other $2.5 million of savings addressed in the report could not be realized because requirements on one item had increased to the extent that $2.2 million of on-order assets that were previously excess were no longer excess, and because it would be uneconomical to terminate a $.3 million repair contract.

Report No. 88-172, "Quick-Reaction Report on the Audit of Contract Terminations at Army Inventory Control Points," June 17, 1988. This report stated that $3.9 million of unneeded spare parts on two Tank-Automotive Command contracts could be terminated with little or no cost to the Government. The report recommended that the Commander, Tank-Automotive Command, recompute requirements for the parts and initiate appropriate action to terminate unneeded spare parts from contracts. Management comments were received from the Director of Supply and Maintenance in the Office of the Deputy Chief of Staff for Logistics. The Director stated that both contracts were terminated. Further, he estimated that the actions saved the Army $3.24 million.

Report No. 88-153, "Contract Terminations at the Navy Aviation Supply Office," May 23, 1988. This report addressed various problems in the process that the Aviation Supply Office used to make termination decisions. First, item managers did not identify, and consider for termination, excess on-order assets. Second, item managers and contracting officers made termination decisions that were not cost-effective. Third, established dollar thresholds precluded excess on-order assets from receiving

termination considerations. The report recommended several actions including: additional procedures for evaluating excess on-order assets, training programs for item managers and their supervisors on validation procedures, critical elements in item managers' and their supervisors' performance plans covering validation of excess on-order assets, procedures for making termination decisions, procedures for using indicators to measure the effectiveness of termination decisions, and procedures requiring termination considerations on all items valued at $20,000 or more. Further, to minimize the cost effects of past decisions not to terminate and to avoid future termination costs, the report also recommended that the Navy use existing excess on-order and on-hand assets as Government-furnished material on production contracts and that the Navy establish procedures for such use on any assets that become excess in the future. The Principal Deputy Assistant Secretary of the Navy (Shipbuilding and Logistics) agreed to act on the recommendations.

Report No. GAO/NSIAD-87-141 (OSD Case No. 7242), "Military Procurement: Air Force Should Terminate More Contracts for On-Order Excess Spare Parts," August 12, 1987. This report stated that the Air Force terminated less than 3 percent of the total value of excess on-order aircraft spare parts. It also stated that the Air Force could terminate substantially more procurements of excess on-order parts, thereby reducing the Government's procurement and inventory holding costs and providing the basis for reduced Air Force funding requests. The General Accounting Office recommended improvements in the system and procedures used to identify excess on-order parts and in the procedures used to make termination decisions. The Assistant Secretary of Defense (Production and Logistics) agreed that improvements were needed. The Assistant Secretary did not agree that future procurement appropriation requests for aircraft could be reduced if the termination process were improved. The Assistant Secretary stated that any such savings would be applied to other pressing requirements.

Report No. GAO/NSIAD-85-55 (OSD Case No. 6670), "The Navy Can Increase Cancellations of Procurements for Unneeded Material," March 22, 1985. This report stated that the Navy's inventory control points canceled less than 1 percent of the excess on-order material that was identified by their automated requirements systems. The General Accounting Office found that the Aviation Supply Office and the Ships Parts Control Center established subjective dollar thresholds for the review of excess material, thereby excluding items from consideration for termination action. Also, the inventory control points reduced the amount of excess on-order material by routinely adding

protection levels in their termination computations. Further, the General Accounting Office found that inventory managers did not review termination notices in a timely manner, as required by procedural guidance. The report recommended that the Navy establish objectively based thresholds for termination reviews, discontinue use of routine protection levels, perform timely and objective termination reviews, require supervisory reviews of termination evaluations, and establish controls over the conduct of the termination review process. The Principal Deputy Assistant Secretary of Defense (Manpower, Installations and Logistics) agreed to act on all recommendations except the one pertaining to protection levels. The Principal Deputy Assistant Secretary maintained that protection levels were necessary to prevent items from vacillating between buy and termination positions.

Report No. GAO/NSIAD-84-42 (OSD Case No. 6370), "Defense Logistics Agency Could Better Identify and Cancel Unneeded On-Order Material," January 10, 1984. This report addressed the procedures and practices for identifying and canceling unneeded on-order material at two supply centers. The General Accounting Office found that excess material was not canceled as a result of inadequacies in the internal controls that monitor item managers' performance. Also, excess material was not identified as a result of the supply centers not considering logistically reassigned assets in their determination of excess on-order material. The General Accounting Office also found that buffer stocks were maintained at excessive levels. The report recommended that the Defense Logistics Agency improve internal controls over the process for identifying excess on-order material; modify the due-in assets review level of reassigned material; and establish, as a cancellation criterion, a variable buffer stock level. The Principal Deputy Assistant Secretary of Defense (Manpower, Installations and Logistics) concurred with the recommendations.

EXISTING PROCEDURES FOR TERMINATION DECISIONMAKING

Department of the Army

Aviation Systems Command

Policy Memorandum No. 16, "Processing Procurement Work Directive (PWD) Cancellations," October 9, 1987, contains the contract termination policy of the Aviation Systems Command. The Policy Memorandum states:

> It is the policy of the Materiel Management Directorate that cancellations of outstanding PWDs are to be held to an absolute minimum.

The Policy Memorandum describes the actions that should be taken on excess on-order assets that are on PWD's, but not yet awarded on contracts, and on PWD's that are on contracts.

For PWD's that are not on contracts, cancellations or quantity decreases are not to be made if the Supply Control Study forecasts a need to procure the item or if the cancellation or quantity decrease action would cause the item to forecast a buy through the apportionment year. In cases where the item manager believes that the items will never be used, cancellation action will be taken after receiving approval authority. The approval authority for PWD's that are identified as being in the Directorate for Procurement and Production is to be obtained from the item manager's branch chief and the applicable procurement contracting officer. If the procurement contracting officer does not agree with the recommended action and the branch chief believes that the cancellation or cutback should be made, the issue is to be elevated up organizational levels for final resolution. For PWD's that are in excess of $10,000 and are outside of the Directorate for Procurement and Production and for which no procurement administrative lead time has accrued, cancellation or cutback approval is to be obtained from the item managers' section chiefs. If procurement administrative lead time has accrued, coordination from the procurement contracting officer is necessary before initiating cancellation or cutback actions. PWD cancellation or cutback actions for less than $10,000 are to be held to a minimum and require the approval of the item manager's branch chief.

For PWD's that are on contracts, cancellations or quantity decreases are not to be made if the Supply Control Study, after the item manager's review, forecasts a need to procure the item through the "Approved Force Acquisition Objective" time frame. If, after validating the requirements data base, the item manager determines that the due-in on a contract is excess to the "Approved Force Acquisition Objective" requirements or that the

item is obsolete, the item manager should take action to cut back or cancel the quantity on contracts in excess of the "Approved Force Acquisition Objective" requirements. The procurement contracting officer will be asked to determine the cancellation or cutback costs and the information will be made a part of the permanent record in the item file. Additionally, for PWD's on contracts, the Policy Memorandum states that cancellations for the convenience of the Government where the majority of obligated funds can be recouped are to be made where feasible. Cancellations where no substantive funds can be recouped will generally not be deemed to be cost-effective and are to be documented as such in the item manager's item file. Before item managers initiate cutback or cancellation actions for PWD's on contract and before the procurement contracting officer is contacted to determine termination costs, approval is to be obtained from the division chief.

Tank-Automotive Command

Policy Memorandum No. 26, "Policy Concerning Changes to Spare/Repair Parts Replenishment Procurement," July 15, 1987, contains the Tank-Automotive Command's contract termination policy. The Memorandum provides the following policy for cutbacks or increases to PWD's not on contracts.

> Once a synopsis of proposed procurement has been released to the Commerce Business Daily or a solicitation has been issued, all changes which affect the quantity being procured on the PWD or total solicitation by more than plus or minus 25% will not be accepted by the Procurement and Production Directorate unless approved by both the Director/Deputy Director of Materiel Systems Management and the Director/Deputy Director of Procurement and Production. Said policy also applies to complete cancellation actions. Exempt from this policy are small purchases valued at $25,000 or less.

The procedures that item managers are to use in satisfying the policy are described below.

- The item manager should contact the buyer to determine what stage the procurement action is in before inputting any changes to the quantity.

- If the solicitation or synopsis has not been written, the item managers should proceed in accordance with existing guidelines regarding cancellations, reductions, and additions.

- If the solicitation or synopsis has been written, a brief justification citing the reason for quantity change must appear on the approved document.

The Policy Memorandum also includes procedures for item managers to use to cut back assets on contracts. The procedures require that the item manager contact the buyer on obligated cutback recommendations when the quantity of excess on-order assets is greater than 12 months beyond the requirements objective. The buyer will determine cost to the Government to cut back or cancel the contract quantity. The item manager will recommend the cutback if the dollar value of the recommended cutback is at least $50,000 and if the cost to cut back does not exceed 50 percent of the dollar value of the contract. Final approval will be in accordance with appropriate approval authority.

Department of the Navy

Aviation Supply Office

Aviation Supply Office Instruction P4000.24, "UICP Replenishment Requirements Determination Manual," April 20, 1973, contains the Aviation Supply Office's policy for contract terminations. The objectives of the policy are to ensure that funds are not expended for material that is no longer needed and to make funds available for more urgent requirements. The Instruction provides the following procedures for processing termination recommendations.

Termination recommendations having a value greater than $300,000 are to be processed in 30 days. The inventory management specialist is to forward all Supply Demand Review termination recommendations to the Supply Demand Review Control Team after the specialist has completed the necessary branch review. The actions of the inventory management specialist will depend on the recommendation of the Control Team. However, if the contracting officer advises that the contractor will charge for termination, the item manager should resubmit the termination recommendation to the Branch Head for a final review.

The Supply Demand Review Control Team is responsible for receiving and reviewing all termination recommendations from

inventory management specialists, for forwarding all contract termination requests to the contracting office, and for returning all recommendations to the inventory management specialists upon completion of the necessary reviews.

The contracting office is not required to request estimated termination charges before notifying the contractor of termination. However, if the contractor advises that significant termination charges will be incurred, the contracting office must notify the inventory management specialist.

The following procedures apply to the termination of procurements that were generated for an end-use requirement that is no longer required.

- If the extended value of the procurement is under $6,000, do not terminate but change markings and reconsign to stock.

- If the extended value of the procurement is over $6,000 and there is no stock procurement in process, do not terminate but reconsign the end-use allocation to a stock.

- If the extended value of the procurement is over $6,000 and there is no stock procurement in process, use the same termination decision rules as for stock buys.

The Instruction also states that when an item is transferred to another activity and material is on an awarded contract, the inventory management specialist is to contact the activity to determine whether the material is needed. If the material is not needed, the contracting officer should terminate the procurement. If the material is required, then the contracting officer should initiate a modification to change the requiring activity.

Department of the Air Force

Air Force Logistics Command Regulation 57-4, Chapter 32, "Termination Actions," contains the Air Force policy on terminations. The regulation states:

> It's Air Force policy to respond to any changes in Air Force missions, programmed objectives, etc., which reduce requirements by cancelling or reducing an order quantities subject to terminations or reductions. This chapter, as well as AF DAR Supplement 8-850, provides policy and guidance to effect timely reduction and termination for investment items.

EXISTING PROCEDURES FOR TERMINATION DECISIONMAKING
(Continued)

The basis for termination or reduction decisions for on-order quantities is also provided in the Regulation. The item manager evaluates output of the automated requirements computation systems when on-order quantities exceed termination levels to determine whether the computation is valid and reduction or termination actions should be initiated. Also, the item manager is to determine whether items with unfunded quantities that are not included in the computation need to be terminated or reduced. Termination action is normally initiated when obsolete items are involved or when a no-cost termination settlement can be obtained. The item manager is to determine whether a no-cost termination settlement may be obtained by requesting estimated termination costs.

The Regulation also states that after determining that on-order quantities are subject to termination, the item manager must review each item within the prescribed time limits to determine the required action. When a reduction in requirements has been initiated and the principal contracting officer, or the termination contracting officer, subsequently determines that contract termination would not be economically feasible, the reduction in requirements would be canceled.

EXAMPLES OF UNECONOMICAL DECISIONS NOT TO TERMINATE EXCESS ON-ORDER ASSETS FROM CONTRACTS

This Appendix provides examples from the reports prepared by the General Accounting Office and the Office of the Inspector General, DoD, on contract terminations at Army inventory control points, at the Navy Aviation Supply Office, and at the Sacramento Air Logistics Center.

Department of the Army

Aviation Systems Command

From July 30, 1986, to December 30, 1986, the Aviation Systems Command (the Systems Command) signed three delivery orders (0504, 0676, and 0375) against contract number DAAJ09-85-G-A017 for the purchase of 1,177 Hollow Horizontal Pins (National Stock No. 1615-01-259-5943, previously 1615-00-871-7302) with unit prices varying from $1,814 to $2,222 (totaling $2.3 million). As of June 30, 1987, 1,165 pins were still due-in from the contractor, and the automated requirements computation system (the computation system) showed that 974 pins on order were excess to requirements. The item manager did not request termination of the 974 unneeded pins because validation of data in the computation systems disclosed that the computation systems did not contain accurate requirements and asset data. After changing the requirements and asset data in the computation systems, the item manager concluded that rather than have excess pins on order, the Systems Command needed all the on-order quantity plus an additional 201 pins. The asset position changed from excess to required because the computation systems did not include 1,836 pins required to support the CH-47D Modernization and Rotorhead Overhaul Programs.

We contacted the contractor responsible for the overhaul programs to determine the validity of the additional requirement for 1,836 pins. The requirement was not valid. The contractor was removing the pins from the aircraft and rotorheads in overhaul, repairing the pins, and returning them to the overhauled aircraft and rotorheads. Furthermore, the contractor was experiencing a 100-percent return from repair and therefore was able to provide all pins required for the overhaul programs.

We presented the information that we obtained from the contractor for the CH-47D overhaul programs to the item manager. The item manager recomputed the requirements for the pins and concluded that 1,165 pins on order and 595 pins on hand were excess to requirements. Furthermore, we concluded that the Systems Command would not have requirements for the on-order pins in the foreseeable future because the Systems Command had 1,605 unserviceable pins that could be repaired to satisfy recurring demands. Those recurring demands would generate additional unserviceable pins that could also be repaired.

Since the 1,165 on-order pins were excess to the Systems Command's needs, we obtained the contractor's cost data as of June 30, 1987, and determined whether the unneeded pins could have been terminated in June 1987. In doing so, we compared the cost of terminating the excess pins with the cost of taking delivery and holding the pins in inventory. We also obtained from the contractor cost data necessary to determine whether the excess pins could be terminated as of March 31, 1988.

We determined that in June 1987 the Systems Command could have terminated 812 of the 1,165 on-order pins with no cash outlay because the contractor had incurred no cost on those pins as of June 30, 1987. Also, by terminating the 812 pins, the Systems Command would have had $1.5 million (the price of 812 pins) to use for other purposes. That $1.5 million was worth $4.2 million to the Government in terms of interest costs. By not terminating the 812 pins, the Systems Command would incur $3.1 million in interest and storage costs. The $3.1 million was calculated by applying a 7.9-percent interest rate and a 1.0-percent storage rate to the value of the 812 unneeded pins to be brought into inventory until used. Based on usage data, it will take about 36 years from April 1989 to use the unneeded pins. Further, we determined that it would have been uneconomical to terminate the other 353 excess on-order pins because the contractor had incurred costs of $700,000 on the 353 pins.

We also determined that as of March 31, 1988, the Systems Command could minimize the cost consequences of bringing 1,165 unneeded pins into inventory. Specifically, we concluded that the Systems Command could terminate from the three orders all pins on which the contractor had incurred either no costs or had incurred costs less than the cost to repair the pins ($1,260 per unit). Also, the Systems Command could arrange for any pins that could not be terminated to be used as offsets to repair programs or to be used as Government-furnished material on the contracts for the overhaul programs. This would prevent the contractor from repairing and reusing pins removed in overhaul.

On October 13, 1988, we issued Report No. 89-004, "Quick-Reaction Report on the Audit of Contract Terminations at Army Inventory Control Points," recommending that the Systems Command take advantage of the opportunities described in the preceding paragraph. The Systems Command replied that it had terminated 817 pins and planned to use the other 348 pins as either Government-furnished material on overhaul contracts or offsets to overhaul and repair programs. The Systems Command estimated that those actions would save $1.3 million. The Systems Command was also determining whether the action will enable it to cancel a $330,000 repair contract.

EXAMPLES OF UNECONOMICAL DECISIONS NOT TO TERMINATE EXCESS ON-ORDER ASSETS FROM CONTRACTS
(Continued)

Tank-Automotive Command

On September 26, 1986, the Tank-Automotive Command (the Command) signed delivery order 0028 against contract number DAAE07-84-G-A006 to purchase 850 Rotor and Shaft Assemblies (National Stock No. 2835-01-074-3454) with unit prices varying from $7,946 to $8,587 and totaling $6,992,745. As of September 30, 1987, 794 of the 850 assemblies were still due-in from the contractor, and the computation system showed that 409 assemblies on order were excess to requirements. The item manager did not request termination of the 409 assemblies because of previous termination considerations on the assemblies.

To evaluate the item manager's decision not to terminate the excess assemblies on order, we compared the cost of terminating the excess assemblies as of September 30, 1987, with the cost of taking delivery and holding the assemblies in inventory until used. We also obtained the contractor's cost data as of March 31, 1988, and determined whether it would have been economical for the contracting officer to terminate the excess assemblies at the time of our audit.

We determined that in September 1987, the Command could have terminated 409 of the 850 assemblies on order. The Command would have incurred no cash outlay in terminating 409 assemblies. The reason was that the contractor had incurred only $61,943 as of September 30, 1987, and that amount represented the material costs for only 13 of the 454 on-order assemblies that were considered for termination. As such, the Command could have terminated all 409 excess assemblies at no cost. Furthermore, by terminating the 409 assemblies, the Command or the Government would have had $3.4 million, which was the contract price of the 409 assemblies, to use for other purposes. The $3.4 million was worth $1,085,411 in terms of interest costs. By not terminating the 409 assemblies, the Command would incur $404,329 in interest and storage costs. The $404,329 was calculated by applying a 7.9-percent interest rate and a 1.0-percent storage rate to the value of the 409 unneeded assemblies to be brought into inventory until used. Based on usage data, it will take about 4 years from October 1988 to use the unneeded assemblies.

We also determined that as of March 31, 1988, the Command could have terminated 301 assemblies, valued at $2.5 million, at little or no cost to the Government. In Report No. 88-172, "Quick-Reaction Report on the Audit of Contract Terminations at Army Inventory Control Points," June 17, 1988, we informed the Command that the 301 assemblies should be terminated. Based on that report, the Command terminated 567 assemblies, valued at $4.7 million.

The Command reported that the termination saved the Army $3.0 million ($4.7 million less $1.7 million for estimated termination costs). Further, subsequent audit effort disclosed that the savings amounted to $4.7 million. The $1.7 million of estimated termination cost was the cost for work that the contractor had in process. We determined that the work in-process could be transferred to other contracts, thereby making the termination of 567 assemblies a no-cost termination.

Department of the Navy

Aviation Supply Office

The Aviation Supply Office's computation system identified as excess on-order assets 16 Main Fuel Controls (National Stock No. 2915-01-074-9903) that were on delivery orders 0347 and 0325 against contract number N00383-83-G-3909. The item manager evaluated the 16 assets in October 1986 and concluded that all 16 were excess to the Aviation Supply Office's needs. However, the item manager did not request that the contracting officer terminate the excess units due to the outcome of an unsuccessful attempt to terminate six excess units in April 1986. Specifically, on April 22, 1986, the item manager requested that the contracting officer terminate six units from delivery order 0347. On May 6, 1986, the contracting officer contacted the contractor by telephone to determine the cost of terminating the six units. Since the contractor stated that termination charges could amount to "60 percent of the unit price," the item manager and contracting officer concluded termination was too costly.

To evaluate the item manager's and contracting officer's decisions not to terminate the excess units, we obtained the contractor's cost data, as of May 31, 1986, and October 31, 1986, for the two delivery orders and compared the cost of terminating the excess units to the cost of taking delivery and holding the units. We also obtained the contractor's cost data as of March 31, 1987, and determined whether it would still be economical for the Aviation Supply Office to terminate the excess units.

We determined that the contracting officer should have terminated six units from delivery order 0347 in May 1986. As of May 31, 1986, the contractor had incurred only $2,164 against the contract price of $217,944 for the six excess units. By including $3,416 in interest on the cost incurred, $216 for profit, and $2,000 for administering the termination, we estimated that it would cost about $7,796 to terminate the

delivery order. By not terminating the six units, we estimate that the Aviation Supply Office could incur as much as $172,778 in holding costs. Further, if the six units are never used except for normal attrition, the Aviation Supply Office could incur an additional $178,713 in investment costs. Therefore, we estimate that the Aviation Supply Office will pay $343,695 ($172,778 plus 178,713 equals $351,491 minus 7,796 equals $343,695) more as a result of not terminating the delivery order.

Our cost calculations also showed that the contracting officer should have terminated 16 units that were reported as excess in October 1986. We estimated the cost to terminate the 16 units would have been approximately $27,791, as opposed to a contract price of $581,184. By including $28,525 in interest on the cost incurred, $2,779 for profit, and $6,000 for administering the termination, we estimated that it would cost about $65,095 to terminate the contract. By not terminating the 16 excess units, we estimate that the Aviation Supply Office could incur as much as $460,741 in holding costs. Further, if the 16 units are never used except for normal attrition, the Aviation Supply Office will incur an additional $476,568 in investment costs. Therefore, we estimate that the Aviation Supply Office will pay $872,214 more as a result of not terminating the delivery order.

On June 5, 1987, we provided the Aviation Supply Office with the results of our review. Based on these results, we recommended that the Aviation Supply Office's best course of action would be to terminate 11 units on delivery order 0347 and 5 units on delivery order 0325.

On July 14, 1987, the Aviation Supply Office informed us: "This item was reviewed using current data and it has been determined that there are 23 excess units on order." As a result, "Action has been taken to completely terminate contract ... [delivery order] 0347 and to terminate 6 units on contract ... [delivery order] 0325." The Aviation Supply Office's actions should result in a reduction of the unnecessary holding and investment costs that we attributed to the 16 excess units on delivery orders 0347 and 0325.

Department of the Air Force

Sacramento Air Logistics Center

The example below is quoted from General Accounting Office Report No. GAO/NSIAD-87-141 (OSD Case No. 7242), "Military Procurement: Air Force Should Terminate More Contracts for On-Order Excess Spare Parts," August 12, 1987.

EXAMPLES OF UNECONOMICAL DECISIONS NOT TO TERMINATE EXCESS ON-ORDER ASSETS FROM CONTRACTS
(Continued)

Stock No. 1560-00-767-8511BJ: A Pitch Feel Assembly Used on the F-111 Aircraft. On August 7, 1984, the Sacramento ALC awarded a contract for 13 of these units at $42,529 each, a total of about $553,000. On December 14, 1985, the D041 system identified all 13 units for possible termination because of decreasing use. This excess on-order quantity represented more than a 9-year supply. The item manager determined that 75-percent of production lead time had expired and, consequently, did not recommend termination. This determination was made on the basis that 10 percent of the contracted quantities were scheduled for delivery. Our analysis disclosed that none of the contracted quantities had actually been delivered and comparing the $909,613 in costs to accept the items ($553,151 for the items and $356,462 for holding costs) with the $67,119 in termination costs ($63,119 contractor incurred cost and $4,000 administrative termination costs) showed that costs of $842,494 could have been avoided by termination .... After we brought this to the attention of the item manager and his supervisor, they reconsidered their earlier decision and recommended that procurement of the 13 excess on-order units be terminated, which was done on July 21, 1986.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301-8000

PRODUCTION AND
LOGISTICS

October 2, 1989

(L/SD)

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING
THROUGH: CHIEF, CAIR, PI for gc 9/28/89.

SUBJECT: Draft Summary Report on the Audits of Contract Terminations (Project No. 8AC-5006.03)

This draft report summarizes the results of three recent audits of contract terminations conducted by the Inspector General, DoD, and the General Accounting Office. The three audits concluded that the Services did not have effective processes and procedures for making economical contract termination decisions at inventory control points. While the actions taken and planned by the Services in response to these audits are characterized as responsive and significant in your draft report, the report also cites a need for further improvement.

The recommendations in this draft report all involve revisions to DoD Instructions, DoD Directives, or a draft DoD Instruction. Each recommendation is discussed in the attachment. However, we also note that the ongoing Defense Management Review involves an intensive survey of all DoD Directives and DoD Instructions and has imposed a moratorium on new and revised Issuances. All proposed actions in the attachment are conditioned upon the final results of this Review. A determination as to what revisions or new Issuances will be implemented will be reached no later than December 15, 1989.

Attachment

Jack Katzen

IG DRAFT REPORT (PROJECT NO. 8AC-5006.03)
DATED JULY 31, 1989

DRAFT SUMMARY REPORT ON THE
AUDITS OF CONTRACT TERMINATIONS

DOD RESPONSE TO THE IG DRAFT REPORT

* * * * * *

PART II - FINDINGS AND RECOMMENDATIONS

RECOMMENDATIONS FOR CORRECTIVE ACTION

RECOMMENDATION B.1. The IG recommended that the Assistant Secretary of Defense (Production and Logistics) (ASD(P&L)) revise the contract termination policy in the Draft DoD Instruction, "Termination of Contracts for Secondary Items No Longer Needed," to a policy requiring the Services to base termination decisions on comparisons of what it will cost to hold unneeded assets in inventory versus the cost to terminate the same unneeded assets from contracts.

RESPONSE. Concur in principle. However, we must emphasize that the determination of what are "unneeded assets" will be made by the inventory manager. As stated in the cover letter, this concurrence in principle is conditional upon the final results of the Defense Management Review's survey of DoD Issuances.

RECOMMENDATION B.2. The IG recommended that the ASD(P&L) supplement the Draft DoD Instruction with procedures requiring contracting officers to obtain and use the following types of information to estimate the cost to terminate excess on-order assets from contracts:

a. Total cost incurred and other financial commitments made by the contractor.

b. Number of completed units being considered for termination.

c. Number of in-process units.

d. Total cost incurred and other financial commitments on in-process units.

e. Amounts of cost incurred and financial commitments that the contractor can transfer to other contracts.

f. Number and value of financial commitments that the contractor can cancel.

RESPONSE. Concur with intent. However, we do not agree that it is feasible to obtain this detailed information from the contractor in a short period of time. Cost and pricing information takes time to prepare. Imposing a new requirement to obtain such time-consuming data conflicts with the auditors' goal of reaching termination decisions in a timely fashion. We believe that the existing guidance in the Draft DoD Instruction that the PCO contact Contract Administration Offices and use appropriate documents is appropriate.

RECOMMENDATION B.3. The IG recommended that the ASD(P&L) specify in the Draft DoD Instruction the extent to which contracting officers can obtain the information in Recommendation B.2 above through requests to the contractors for cost and pricing data that are shown in Item 7C, Table 15-2, Subsection 15-804-6, of the Federal Acquisition Regulation.

RESPONSE. Concur with intent. However, we believe sufficient guidance exists in the FAR so that further discussion is not required in the Draft DoD Instruction.

RECOMMENDATION B.4.A. The IG recommended that the ASD(P&L) supplement the Draft DoD Instruction with procedures requiring that termination coordinators at inventory control points monitor, act on, and report to their respective Services the number and dollar value of excess on-order assets that inventory control points terminated, the timeliness of termination actions, the estimated versus actual savings on termination actions, the number and dollar value of excess on-order assets for which termination decisions could not be made due to the lack of contractual data, and the reasons why high dollar value excess on-order assets could not be terminated from contracts.

RESPONSE. Concur with intent. However, this level of detailed requirement is not appropriate for inclusion in a DoD Instruction. Rather, the Military Departments in their implementation should review the need for such requirements.

RECOMMENDATION B.4.B. The IG recommended that the ASD(P&L) supplement the Draft DoD Instruction with procedures requiring the Services to monitor performance data reported by inventory control points and to act on unfavorable trends indicated by the reported data.

RESPONSE. Concur with intent. Again, this type of requirement should be considered by the Military Departments rather than be included in a DoD Issuance.

RECOMMENDATION B.4.C. The IG recommended that the ASD(P&L) supplement the Draft DoD Instruction with procedures requiring Inventory Control Points to make termination decisions within a prescribed number of days after the computation systems notify the item managers that assets are excess to current requirements.

RESPONSE. Concur with intent. Again, this level of requirement should be considered by the Military Departments rather than included in a DoD Issuance.

RECOMMENDATION B.4.D. The IG recommended that the ASD(P&L) supplement the Draft DoD Instruction with procedures requiring contracting officers to provide administrative contracting officers with the contractual cost data that they used to make termination decisions, and requiring administrative contracting officers to provide contracting officers with negotiation memorandums that show settlement costs resulting from terminations.

RESPONSE. Concur with intent. Paragraph F.5. of the Draft DoD Instruction provides sufficient information to comply with the intent of this recommendation.

RECOMMENDATION B.4.E. The IG recommended that the ASD(P&L) finalize and issue the draft DoD Instruction.

RESPONSE. Concur in principle. However, as pointed out in the cover letter, this concurrence is conditioned on the completion of the Defense Management Review survey of Issuances.

RECOMMENDATION C.1. The IG recommended that the ASD(P&L) revise the retention policy in Paragraph D.1. of DoD Directive 4100.37, "Retention and Transfer of Material Assets," to require the Services to use, as Government-furnished material, on-order assets that are beyond the requirements objective and that cannot be terminated from contracts.

RESPONSE. Concur with intent. However, GFM requirements, when known, are included in total requirements computations. Therefore, they are already considered when making termination decisions.

RECOMMENDATION C.2. The IG recommended that the ASD(P&L) supplement Paragraph II of DOD Instruction 4140.41, "Government-Owned Material Assets Utilized as Government Furnished Material for Major Acquisition Programs," to include the responsibilities for inventory control points to identify on-order assets that are beyond requirements objectives, that cannot be terminated from contracts economically, and that are applicable to items in production.

Inventory control points should also arrange for such assets, as well as similar on-hand assets, to be used as Government-furnished material on production contracts.

RESPONSE. Concur with intent. However, as pointed out above, requirements for GFM are already included in the requirements computation. Therefore, they are already considered when making termination decisions.

RECOMMENDATION C.3. The IG recommended that the ASD(P&L) revise Paragraph F.3. in DoD Instruction 4140.48, "Control of Access to DoD Material Inventories Required by Defense Contractors," to require the Services to provide to contractors, as Government-furnished material, on-order assets that are beyond the requirements objective and that cannot be terminated from contracts economically.

RESPONSE. Concur with intent. However, see response to Recommendation C.2. above.

RECOMMENDATION C.4. The IG recommended that the ASD(P&L) supplement Draft DoD Instruction, "Termination of Contracts for Secondary Items No Longer Needed," with requirements for: a. Inventory control points to: (1) Calculate and include the cost of the Government-furnished material option as a part of economic analysis... (2) Report the extent that excess on-order assets that cannot be terminated to economical reasons are applicable to higher assemblies that are in production, and the extent...used on production contracts... b. the Services to monitor reports from inventory control points on the use and non-use of excess on-order assets as Government-furnished material.

RESPONSE. Concur with intent. However, implementation beyond the specific inclusion of the GFM option in F.6. of the Draft DoD Instruction is not practical due to high costs of collecting such data.

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Office of the Deputy Assistant Secretary of Defense (Procurement), Office of the Assistant Secretary of Defense (Production and Logistics), Washington, DC

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Office of the Assistant Secretary of the Army (Research, Development and Acquisition), Washington, DC
Office of the Deputy Chief of Staff (Logistics), Washington, DC
Headquarters, Army Materiel Command, Alexandria, VA
Army Aviation Systems Command, St. Louis, MO
Army Tank-Automotive Command, Detroit, MI
Army Contracting Command, Europe, Frankfurt, Germany Contracting Centers:
- A.B. Haegglund and Soener, Oernskoeldsvik, Sweden
- ITT Nederland, The Netherlands

Army Plant Representative Offices:
- Bell Helicopter Textron, Fort Worth, TX
- Boeing Helicopter Company, Philadelphia, PA
- McDonnell Douglas Helicopter Company, Mesa, AZ

Department of the Navy

Office of the Assistant Secretary of the Navy (Shipbuilding and Logistics), Arlington, VA
Deputy Chief of Naval Operations (Air Warfare), Aviation Plans and Requirements Division, Washington, DC
Naval Supply Systems Command, Arlington, VA
Navy Aviation Supply Office, Philadelphia, PA
Navy Plant Representative Offices:
- General Electric Company, Aircraft Engine Business Group, Lynn, MA
- Gruman Aerospace Corporation, Bethpage, NY
- Lockheed - California Company, Burbank, CA
- United Technologies Corporation/Sikorsky Aircraft Division, Stratford, CT

Naval Regional Contracting Center Detachment, London, England, United Kingdom
- Lucas Aerospace Limited, Power Systems Division, Hemel Hempstead, United Kingdom

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- San Antonio Air Logistics Center, Kelly Air Force Base, TX

Air Force Plant Representative Office, Hughes Aircraft Company, Los Angeles, CA

Defense Agencies

Defense Logistics Agency, Alexandria, VA

Defense Contract Administration Services Plant Representative Offices:
- General Electric Company, Burlington, VT
- Goodyear Aerospace Corporation, Akron, OH
- Kaman Aerospace Corporation, Bloomfield, CT
- Lear Siegler, Incorporated, Instrument and Avionic Systems Division, Grand Rapids, MI
- Litton Systems, Incorporated, Woodland Hills, CA
- Rockwell International Corporation, Richardson, TX
- Sundstrand Aviation Corporation, Rockford, IL
- Texas Instruments, Incorporated, Dallas, TX
- Textron Corporation, Textron Lycoming Division, Stratford, CT
- United Technologies Corporation, Hamilton Standard Division, Windsor Locks, CT

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- Mack Plastics Corporation, Briston, RI

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- Diversco, Incorporated, Harvey, IL
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- Metro Machine Works, Incorporated, Romulus, MI
- Ordnance Materials, Incorporated, Farmington Hills, MI
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- Stalker Corporation, Essexville, MI

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- Simmonds Precision Products, Incorporated, Vergennes, VT
- W & G Machine Company, Incorporated, Hayden, CT

Indianapolis, IN
- Bendix Corporation, South Bend, IN
- Memcor - Trushm, Incorporated, Huntington, IN

Inglewood, CA
- Airsearch Manufacturing Company, Torrance, CA

New Orleans, LA
- Chem-Fab Corporation, Hot Springs, AR

Orlando, FL
- Allied Corporation, Bendix Engine Product Division, Jacksonville, FL
- Pall Land and Marine Corporation, New Port Richey, FL
- Simmonds Precision Products, Incorporated, Fort Lauderdale, FL

Ottawa, Canada
- Canadian Commercial Corporation, Ontario, Canada

San Diego, CA
- Renar Industries, Incorporated, San Diego, CA

San Francisco, CA
- Kaiser Aerospace and Electronic Company, San Jose, CA
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- Parker Hannifin Corporation, Irvine, CA

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- Sier-Bath Gear Company, Incorporated, North Bergen, NJ

Van Nuys, CA
- Borg Warner Fluid Controls, Van Nuys, CA
- ITT General Controls Aerospace, Burbank, CA
- Sargent Industries, Burbank, CA
- Teledyne Camera Systems, Arcadia, CA

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