# Audit Report

OFFICE OF THE INSPECTOR GENERAL

**REQUIREMENTS FOR AND ADMINISTRATION OF THE FERROALLOY UPGRADE PROGRAM**

Report No. 94-034

February 7, 1994

## Department of Defense

**Acronyms**

| | |
|---|---|
| CAS | Cost Accounting Standards |
| CY | Contract Year |
| DLA | Defense Logistics Agency |
| FAR | Federal Acquisition Regulation |
| FEMA | Federal Emergency Management Agency |
| GAO | General Accounting Office |
| GSA | General Services Administration |

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

February 7, 1994

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (ECONOMIC SECURITY)
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Requirements for and Administration of the Ferroalloy Upgrade Program (Report No. 94-034)

We are providing this final report for your information and use. It discusses matters concerning the ferroalloy upgrade program administered by the Defense National Stockpile Center, an element of the Defense Logistics Agency. The audit was requested by the Office of the Assistant Secretary of Defense (Economic Security), formerly the Office of the Assistant Secretary of Defense (Production and Logistics).

Management comments on a draft of this report were considered in preparing the final report. At this time, management comments meet the intent of DoD Directive 7650.3 and additional comments are not required.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Harlan M. Geyer at (703) 692-2830 (DSN 222-2830) or Mr. George J. Sechiel at (703) 692-2834 (DSN 222-2834). If you have requests or suggestions for future audits please contact us. The distribution of this report is listed in Appendix E.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

**Office of the Inspector General, DoD**

Report No. 94-034 February 7, 1994
Project No. 2RA-5002

# REQUIREMENTS FOR AND ADMINISTRATION OF THE FERROALLOY UPGRADE PROGRAM

## EXECUTIVE SUMMARY

**Introduction.** The ferroalloy upgrade program (the Program) was established on November 29, 1982. The stated objectives of the Program were to lessen the amount of stockpiled ores needing conversion to ferroalloys during times of national emergency and to help maintain existing U.S. ferroalloy furnace and processing capability. The Program was limited to chromite and manganese ores. The two contractors doing the upgrade work were reimbursed a total of $457 million in commodities, cash, and payments in kind, from January 1, 1984, through July 30, 1992. The audit was requested by the Deputy Assistant Secretary of Defense (Production Resources), Office of the Assistant Secretary of Defense (Economic Security), formerly the Office of the Assistant Secretary of Defense (Production and Logistics).

**Objectives.** The audit evaluated the methodology and procedures for awarding and administering contracts for the Program and assessed the implementation of the internal management controls as they pertained to the Program. In addition, the audit evaluated the need to continue stockpiling ferrochromium and ferromanganese in the National Defense Stockpile (the Stockpile).

**Audit Results.** The objectives of the Program were not achieved, and the administration of the contracts involved did not comply with procurement directives.

o The Program increased the already excess quantities of ferrochromium and ferromanganese stored in the Stockpile. Contracts awarded on September 30, 1992, for contract years 1993 and 1994 will add to the excesses. The contracts could have been terminated without a detrimental impact on the national security and would have reduced the overall cost incurred by the Government (Finding A).

o The Defense National Stockpile Center (the Center) did not administer the Program contracts in accordance with procurement directives. As a result, the Center improperly reimbursed a contractor to overhaul a furnace and unnecessarily allowed indirect costs to bring the contractors' accounting systems into compliance with cost accounting standards for the last 2 years of the contracts. Further, Program data reported to Congress could not be reconciled with documentation in the contract files (Finding B).

**Internal Controls.** The Center had implemented the Federal Managers' Financial Integrity Act of 1982 as required by Defense Logistics Agency Regulation 5010.4, "Internal Management Control Program," October 12, 1990, as it pertained to the Program. However, established management controls did not ensure that the correct methods and procedures were followed in awarding and managing the contracts for the Program, resulting in material internal control weaknesses. Details on the controls reviewed are provided in the Internal Control section in Part I of this report, and details on the weaknesses are provided in Appendix C.

**Potential Benefits of Audit.** Expenditures from the National Defense Stockpile Transaction Fund will be reported properly, and an improper reimbursement of $1.2 million for furnace repairs will be offset against contract costs for one of the contractors. Also, about $250,000 in upgrade payments could be avoided by waiving the requirement to bring a contractor's accounting system into compliance with cost accounting standards and reducing the indirect costs for the contracts. Details on the other benefits resulting from the audit are in Appendix D.

**Summary of Recommendations.** We recommended that legislation be proposed to eliminate the requirement to convert stockpiled ores into ferroalloys for contract years 1993 and 1994. Also, we recommended that the funding for the contractor's furnace be reported to Congress and offset against the contract costs; a waiver be requested releasing the contractors from the requirement for compliance with the cost accounting standards; the contracts be renegotiated to remove indirect costs associated with bringing the contractors' accounting systems into compliance with cost accounting standards; and, all completed contracts be closed in compliance with the Federal Acquisition Regulation (FAR).

**Management Comments.** The then Assistant Secretary of Defense (Production and Logistics) agreed there was an excess of ferrochromium and ferromanganese and stated Congress refused in the past, and that it was now too late to request Congress to cancel the remainder of the Program. The Assistant Secretary also agreed to the reporting of costs to rebuild a furnace in the Annual Materials Plan. The Defense Logistics Agency proposed using a defective pricing audit to determine the validity of the furnace rebuild costs, to recover indirect cost payments to one contractor for not upgrading its accounting system and to properly close-out the contracts.

The management refusal in 1993 to request Congress to terminate the Program and the fact that the contracts will be completed in 7 months makes additional management comments unnecessary at this time. Details on management's comments are in Part II of the report, and the full texts of managements' comments are in Part IV.

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This report was prepared by the Readiness and Operational Support Directorate, Office of the Assistant Inspector General for Auditing, DoD. Copies of the report can be obtained from the Secondary Reports Distribution Unit, Audit Planning and Technical Support Directorate (703) 614-6303 (DSN 224-6303).

# Part I - Introduction

## Background

Chromite and manganese ores are used in the steel-making process; however, the ores must be upgraded to a ferroalloy form before they are used. Ferrochromium is used as an alloying agent in the production of stainless steel, and ferromanganese is used as a strengthening agent in the manufacture of steel. Because neither ore is found in sufficient qualities and quantities in the United States to support the steel industry, the ores must be imported.

The ore producing countries started converting chromite and manganese ores into the ferroalloys because the ferroalloys were more marketable than the ores. The ore producing countries sell ferrochrome and ferromanganese on the world market for less than the U.S. ferroalloy industry produces the two ferroalloys. As a result, the U.S. ferroalloy industry began to decline in the 1970's.

On August 18, 1981, the Ferroalloys Association, representing all U.S. ferroalloy producers, filed an application with the Department of Commerce to investigate the effect on national security of the importing of chromium, manganese, and silicon ferroalloys and related materials. The application was filed under the provisions of section 232 of the Trade Expansion Act of 1962 (United States Code, title 19, section 1862), which requires the Secretary of Commerce, in consultation with the Secretary of Defense, to investigate the effect of imports on national security. The Department of Commerce's investigation concluded that the need to import ferrochrome and ferromanganese posed a threat to national security. The investigation also concluded that a highly qualified domestic ferroalloy industry was capable of meeting foreign competition. However, the high labor, energy, and environmental costs associated with domestic production caused U.S. produced ferroalloys to be expensive. The results of the Department of Commerce's investigation showed that as of August 1982, there were 101 ferroalloy producing furnaces in the United States, of which 6 were capable of producing high carbon ferrochrome or ferromanganese. The Department of Commerce's report recommended that chromite and manganese ores in the National Defense Stockpile (the Stockpile) be upgraded to high carbon ferrochrome and high carbon ferromanganese to eliminate shortfalls of the two ferroalloys in time of a national emergency.

A November 29, 1982, Presidential memorandum directed that the chromite and manganese ores in the Stockpile be upgraded to ferroalloys. The memorandum specified the quantities of the ferroalloys that would be produced over a 10-year period. Also, the memorandum provided that the upgrade program be designed to "...lessen the amount of stockpiled ore needing conversion into ferroalloy form during time of national emergency ... help maintain existing ferroalloy furnace and processing capacity...."

The Defense Authorization Act for FY 1987, Public Law 99-661, codified the ferroalloy upgrade program, directed that the program continue for 7 fiscal years, and specified the minimum quantities of the ferroalloys to be produced each year.

Invitations to bid on the ferroalloy upgrade program (the Program) were sent to identified producers of ferroalloys in April 1983. Bids were received from four companies to upgrade chromite ore and from two companies to upgrade manganese ore. One company submitted separate bids to upgrade both ores. The first contracts to upgrade the two ores were awarded on December 30, 1983, and work on the Program was to start January 1, 1984.

The contracts specified the approximate amount of each ore to be upgraded during the contract year (CY) and the amount to be paid for each short ton unit[1] of high carbon ferroalloy returned to the Stockpile. The contracts also specified that the contractors would receive commodities excess to Stockpile requirements in exchange for converting the ores to ferroalloys. Excess Stockpile commodities were exchanged for upgrade services from the start of the Program. In CY 1988, the contracts were amended to allow the contractors to be paid in cash. Cash payments were made in CYs 1988, 1989, and 1990. Payment in kind (the ferroalloys being produced) was authorized for CYs 1992, 1993, and 1994. Appendix A shows the short tons and short ton units of the two ferroalloys received from the contractors through July 31, 1992, and the value of the commodities exchanged, cash paid, and payments in kind for the upgrade services. Although all identified ferroalloy producers were solicited each time it was necessary to award a new contract to continue the Program, the two contractors awarded the initial upgrade contracts were the only bidders on the follow-on solicitations.

The General Services Administration (GSA) administered the Stockpile, and the Federal Emergency Management Agency (FEMA) determined items and the quantity of items to be stocked in the Stockpile at the time the Program began in 1984. The responsibility for management of the Stockpile was transferred to the Secretary of Defense in Executive Order 12626, February 25, 1988. In May 1988, the Secretary of Defense delegated management responsibility, including requirements computations, for the Stockpile to the then Assistant Secretary of Defense (Production and Logistics) (the responsibility was transferred to the Assistant Secretary of Defense (Economic Security) in October 1993). Authority to administer the Stockpile was delegated to the Defense National Stockpile Center (the Center), a component of the Defense Logistics Agency.

## Objectives

The audit was requested by the Deputy Assistant Secretary of Defense (Production Resources), Office of the Assistant Secretary of Defense (Production and Logistics). Our objectives were to evaluate the methodology

[1] The short ton unit is an industry standard used to measure the metal (chromite or manganese) contained in the ferroalloy. The percentage of metal is determined by an independent chemical analysis, multiplied by the weight, then multiplied by 100 to obtain the short ton units.

and procedures followed in awarding and administering contracts for the Program and to assess the applicable internal controls. Also, we evaluated the requirements to continue stockpiling the ferrochromium and ferromanganese.

## Scope

We reviewed the files of all contracts for the Program awarded from December 31, 1983, through September 30, 1992, to determine whether the Program was implemented as directed. We also determined whether the contracts were awarded and administered in accordance with Federal procurement directives. We reviewed the Outbound Shipping Reports to determine the amount of ore shipped to the contractors' plants for upgrading from January 1, 1984, through July 30, 1992. We reviewed receiving reports for the same period to determine the amount of ferroalloy contractors returned to the Stockpile. We also reviewed disposal actions and cash payment vouchers to determine whether contractors were properly reimbursed for upgrading services.

To determine the need to continue stockpiling ferrochromium and ferromanganese in the Stockpile, we reviewed the 1989 and 1992 "Reports to the Congress on National Defense Stockpile Requirements" and the semiannual "Strategic and Critical Materials Report to the Congress," dated from April 1983 though September 1991. In addition, we interviewed personnel at the Office of the Deputy Assistant Secretary of Defense (Production Resources) to determine how the requirements were computed and if the computations for the two ferroalloys were processed in the same manner as the requirements for other Stockpile ores. Also, we interviewed personnel at the Institute for Defense Analysis to determine how the computer model was used to calculate Stockpile requirements. We did not assess the computer models or assumptions because Inspector General, DoD, Report No. 91-112 evaluated the requirements computation process and GAO Report No. NSIAD-93-60 reviewed the assumptions and methodologies used in determining the Stockpile requirements (see Prior Audits and Other Reviews).

This program audit was made in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD, and included such tests of internal controls as were considered necessary. We did not rely on computer-generated data to reach our audit conclusions. The audit was made from June 1992 through February 1993 at the Office of the Deputy Assistant Secretary of Defense (Production Resources), the Center, and the Institute for Defense Analysis and included transactions that were current as of September 30, 1992.

## Internal Controls

In assessing the Center's implementation of the Federal Managers' Financial Integrity Act of 1982 as it applied to the Program, we 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. The Center had implemented an internal management control program as required by the Federal Managers' Financial Integrity Act; however, the controls established were not sufficient to ensure that the ferroalloy upgrade contracts were awarded and administered in accordance with Federal procurement regulations.

We made no recommendations to correct the internal control weaknesses discussed in Appendix C of the report because the Program will be completed in 7 months. A copy of this report will be provided to senior officials responsible for internal controls within the Defense Logistics Agency.

## Prior Audits and Other Reviews

The General Accounting Office (GAO) report on the Stockpile, Report No. NSIAD-93-60 (Office of the Secretary of Defense Case No. 9265), "Views on DoD's 1992 Report to the Congress and Proposed Legislation," March 1993, reviewed the assumptions and methodologies used in determining DoD's material requirements, the plans to dispose of unneeded Stockpile materials and acquire needed ones, and the ferroalloy upgrade program. GAO determined that DoD's methodology for generating requirements was limited as a basis for determining specific estimates of requirements because some assumptions and other data have a significant degree of uncertainty. GAO also determined that DoD could dispose of obsolete materials without risk to national security but advised caution in disposing of some materials because of the shortcomings in the requirements determination process. GAO recommended that future determinations of requirements be based on a broader range of sensitivity tests to assess the uncertainties associated with a variety of assumptions. GAO also recommended that Stockpile managers use a committee of experts in planning and implementing acquisitions and disposals. Specific recommendations concerning the ferroalloy upgrade program were not made; however, GAO concluded that the Stockpile inventories of ferrochromium and ferromanganese exceeded DoD's requirements and that the alloys could be obtained from several other sources in an emergency. GAO also concluded that the continued procurement of the alloys under the upgrade program is neither necessary nor economical.

Inspector General, DoD, Audit Report No. 91-112, "Requirements for the National Defense Stockpile," July 19, 1991, evaluated the process for determining the types, quantities, and qualities of materials to be acquired for and retained in the Stockpile. The report concluded that the process needed improvement. The report recommended that future requirements computations reflect a more realistic military force level and domestic production capacity

from new and reopened facilities and consider foreign sources of supply other than Canada and Mexico. Management concurred in the recommendations and stated that corrective actions would be used in computing the 1991 Stockpile requirements.

The Inspector General, GSA, issued five reports on audits of the contractors' proposed costs for CYs 1987, 1988, and 1989, and the Defense Contract Audit Agency issued seven reports on audits of the proposed costs for CYs 1990 through 1994 (Appendix B). In each audit, some contractors' costs were questioned. The questioned costs were resolved during contract negotiations.

## Other Matters of Interest

We identified problems with the methodology and procedures followed by the GSA and the Center in awarding and administering contracts for the Program (Appendix C). However, the report contains no recommendations to correct those problems because the Program will end in 7 months.

# Part II - Findings and Recommendations

# Finding A. Ferroalloy Upgrade Program Requirements

The Center awarded two contracts to upgrade chromite and manganese ores in CYs 1993 and 1994, even though both ferroalloys were excess to Stockpile requirements. The contracts were awarded because Public Law 99-661, the DoD Authorization Act for FY 1987, directed that the Program continue through FY 1993 and specified the minimum short tons of each ferroalloy to be placed in the Stockpile through FY 1993. Also, Public Law 99-661 provided that when the minimum quantity was not met, the deficiency would be added to the next fiscal year's minimum quantity. The cost to the Government, in terms of commodities transferred or payments in kind, would have been substantially reduced by terminating the Program without endangerment to national security. At April 30, 1993, the date the results of the audit were submitted to management, the cost reductions were estimated at $63 million.

## Background

The 1982 Presidential memorandum establishing the Program specified that 576,822 short tons of high carbon ferromanganese and 518,500 short tons of high carbon ferrochromium would be produced over a 10-year period. The Defense Authorization Act for FY 1987, Public Law 99-661, section 3205, "Conversion Of Chromium And Manganese Ore To High Carbon Ferrochromium And High Carbon Ferromanganese," codified annual amounts of high carbon ferroalloys to be produced for each of the remaining Program years. For fiscal years 1987 through 1993, the law required that a minimum of 67,500 short tons of high carbon ferromanganese and 53,500 short tons of high carbon ferrochromium be added to the Stockpile. The law also allowed any deficiency not produced in one fiscal year to be carried over to the following fiscal year.

## Ferroalloy Requirements

In 1983, when the Program was initiated, GSA was responsible for managing the Stockpile and FEMA was responsible for determining Stockpile requirements. FEMA had computed requirements for the two ferroalloys in 1980, and the requirements were still in effect when the Program started. In 1983, however, the on-hand quantities of the two ferroalloys exceeded the computed requirements when GSA solicited bids to start the Program. GSA recognized the problem and in July 1983, asked FEMA to compute new requirements for the two ferroalloys. GSA suggested that requirements be

based on the family groups of the two ferroalloys. Family groups consist of the various grades of an ore and the related ferroalloys. The chromium family has six members: chemical grade ore, metallurgical grade ore, high carbon ferro, low carbon ferro, silicon ferro, and metal. The manganese family has seven members: chemical grade ore, metallurgical grade ore, high carbon ferro, low carbon ferro, medium carbon ferro, silicon ferro, and electrolytic metal. Basing new requirements on family groupings caused the misconception that the ferroalloys were needed, because the on-hand balances of some of the family members were less than the computed requirements.

When DoD became responsible for Stockpile management in 1988, the Deputy Assistant Secretary of Defense (Production Resources) was designated to compute Stockpile requirements. The Institute for Defense Analysis was selected to assist in computing the Stockpile requirements. DoD computed Stockpile requirements for FYs 1989, 1991, and 1992. FY 1992 Stockpile requirements were based on the mandated scenario of a 3-year global conflict with a 1-year mobilization period. Stockpile requirements are computed using quantitative computer models that derive material requirements from a set of total demands on the economy. The models consider the estimates of materials available from domestic and reliable foreign sources. The requirements are then compared to quantities on-hand in the Stockpile to determine what action, if any, is needed to satisfy the requirement.

## Ferroalloy Excesses

As previously stated, the on-hand quantities of each ferroalloy in the Stockpile were excess to computed requirements when the Program started. Analysis of the quantity of the two ferroalloys showed that the excesses increased from the start of the Program through FY 1991. The ferromanganese excess has increased nearly 270 percent since the Program started, while the ferrochromium excess has increased 15 percent (see Figures 1 and 2). In the 1992 Report to the Congress on Stockpile Requirements, DoD stated that the Stockpile requirements were much higher than necessary to meet actual military threats because they were based on the mandated 3-year war scenario. The inventory quantities shown in Figures 1 and 2 do not include the ferroalloys produced in CY 1992. In addition, the Program is producing additional excesses because the Center awarded contracts to continue upgrading the two ores until December 31, 1994.

Figure 1. Ferromanganese

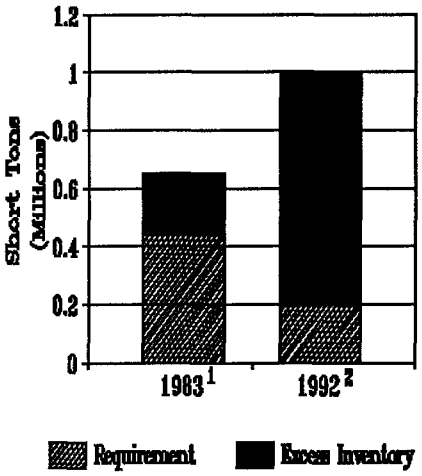
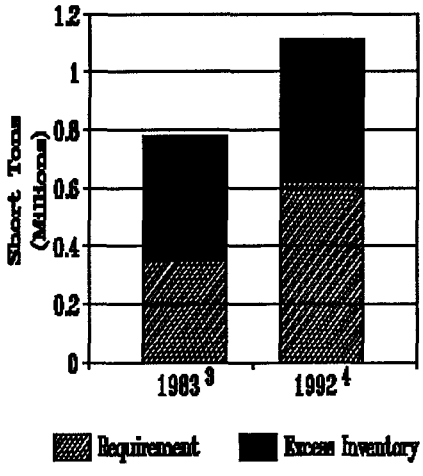



Figure 2. Ferrochromium




[1] The requirement was 439,000 short tons; the inventory was 652,472 short tons; the excess was 213,472 short tons.

[2] The requirement was 209,074 short tons; the inventory was 995,329 short tons; the excess was 786,255 short tons.

[3] The requirement was 350,000 short tons; the inventory was 779,945 short tons; the excess was 429,945 short tons.

[4] The requirement was 621,204 short tons; the inventory was 1,116,120 short tons; the excess was 494,916 short tons.

Section 3205 of Public Law 99-661 would have to be repealed in order to terminate the Program and eliminate the excesses of the two ferroalloys that would be produced during CYs 1993 and 1994. DoD officials submitted a legislative proposal to terminate the Program in January 1992. The proposed legislation was not acted on by the 102d Congress. However, we believe that this finding provided additional information for consideration and that the proposal to repeal section 3205 of Public Law 99-661 should have been resubmitted in the Department of Defense Legislative Program.

In addition to adding excesses to the Stockpile, the Program has not achieved its objectives to maintain U.S. ferroalloy furnace processing capability. In 1982, when the Department of Commerce investigation was made, six furnaces in the United States were capable of producing high carbon ferroalloys. At the time of the audit, the only U.S. furnaces producing high carbon ferroalloys were the ones operated by the two Program contractors.

## Contract Termination

Federal Acquisition Regulation (FAR) part 49.502, "Termination for Convenience of Government," allows the Center to terminate both ferroalloy

contracts if they are no longer needed. FAR part 49.502 requires the Center to pay the contract price for completed services; the costs incurred in the performance of the work terminated, including initial costs and preparatory expense; the cost of settling and paying termination settlement proposals under terminated subcontracts; and a fair and reasonable profit. We computed the estimated cost of terminating the contracts using the amount of the awarded contracts for CYs 1993 and 1994. The actual costs incurred would not be known unless the contracts are terminated. We were able to estimate the cost of completed work through April 1993 and the cost of moving the ore that was scheduled to be upgraded during CY 1993 to the contractors' sites. The table below shows the estimated costs associated with terminating the contracts.

Termination Costs and Estimated Savings
as of April 30, 1993

| | Overall Total ($000) | Ferromanganese 1993 ($000) | Ferromanganese 1994 ($000) | Ferromanganese Total ($000) | Ferrochromium 1993 ($000) | Ferrochromium 1994 ($000) | Ferrochromium Total ($000) |
|---|---|---|---|---|---|---|---|
| Contract Value | $89,671 | $38,505 | $5,212 | $43,717 | $29,870 | $16,084 | $45,954 |
| Liabilities: | | | | | | | |
| Costs Incurred | $22,790 | $12,834 | 0 | $12,834 | $9,956 | 0 | $9,956 |
| Ore Transport | 3,804 | 1,642 | 0 | 1,642 | 2,162 | 0 | 2,162 |
| Estimated Liabilities | 26,594 | 14,476 | 0 | 14,476 | 12,118 | 0 | $12,118 |
| Estimated Savings | $63,077 | $ 24,029 | $5,212 | $29,241 | $17,752 | $16,084 | $33,836 |

Using contract termination procedures specified in the FAR, we estimated it will cost the Government about $27 million to terminate the contracts for CYs 1993 and 1994. The estimated value of both contracts for CYs 1993 and 1994 is approximately $90 million, which will be reimbursed by payments in kind materials or exchanges of excess Stockpile commodities.

## Recommendation, Management Comments, and Audit Responses

**We recommend that the Assistant Secretary of Defense (Production and Logistics) include a proposal in the Department of Defense Legislative Program to repeal section 3205 of Public Law 99-661, which will terminate the requirement to convert chromium and manganese held in the National Defense Stockpile into high carbon ferroalloys.**

**Management Comments.** The then Assistant Secretary of Defense (Production and Logistics) and the Defense Logistics Agency (DLA) agreed that the ferroalloy upgrade program could be terminated without affecting national

security. Both organizations expressed reservations with the statement that a cost avoidance of $63 million in payments in kind or exchanges of excess materials could be realized if the contracts were terminated by April 30, 1993.

The then Assistant Secretary concurred in part stating that legislation had been proposed in the past to repeal the public law that codified the ferroalloy upgrade program. Since the FY 1994 DoD Legislative Program has already been submitted to Congress, the proposal cannot be resubmitted in 1993. The Program will be completed before there is a chance to submit remedial legislation.

**Audit Response.** The DoD did not submit a proposal to terminate the ferroalloy upgrade program and the time has passed for Congress to act. As a result, the Program will be completed by December 31, 1994. No additional action is required.

**Deleted Recommendation.** Based on management comments, we deleted a recommendation to terminate the contracts for the Program.

# Finding B. Contract Administration

The Center did not adequately administer the ferroalloy upgrade contracts or close out completed contracts. This occurred because the Center did not follow procedures established in the FAR when awarding and administering the ferroalloy upgrade contracts and did not verify that funds were used as prescribed in the Strategic and Critical Materials Stock Piling Act. As a result, an expenditure of $1.2 million was improperly made from the National Defense Stockpile Transaction Fund (Transaction Fund) before it was reported to Congress in the Annual Materials Plan for approval as required by the Act. The expenditure directly reimbursed a Program contractor for the cost of rebuilding a furnace. Those costs were included as furnace maintenance and operation costs and depreciation in the unit prices paid in the normal performance of the contract. In addition, the Center allowed the two contractors to include $250,000 each in indirect costs to make their accounting systems comply with cost accounting standards (CAS) in the CY 1993 and 1994 contracts. Also, Program data reported to Congress was not reconcilable with documentation in the contract files.

## Background

The Transaction Fund is a separate fund established in the Treasury of the United States by the Strategic and Critical Materials Stock Piling Act (United States Code, title 50, section 98) (the Act). The monies in the Transaction Fund are available for the acquisition of strategic and critical materials; transportation, storage, and other incidental expenses related to such acquisitions; and development of specifications of Stockpile materials. Also, Transaction Fund monies can be used for upgrading existing Stockpile materials to meet current specifications, testing and quality studies of Stockpile materials, studying future material and mobilization requirements for the Stockpile, encouraging the development of domestic sources for materials determined to be strategic and critical material, and researching to improve the quality and availability of materials stockpiled.

FAR subpart 30.101, "Cost Accounting Standards," requires Defense contractors and subcontractors to comply with CAS. The FAR requires Defense contractors to comply with all CAS in effect on the date of contract award. Both ferroalloy upgrade contracts were subject to CAS because the contracts were valued at more than $10 million each. Defense contractors required to comply with CAS must disclose in writing and follow consistently their own cost accounting practices. CAS coverage is not required for non-Defense contracts. Therefore, the contractors doing the work required of the Program did not have to comply with CAS when the Program was administered by GSA. However, when DoD was made responsible for managing the Stockpile in 1988, the contractors' accounting systems had to comply with CAS.

FAR part 4.804.1, "Closeout by the Office Administering the Contract," provides that "...firm fixed-price contracts for other than small purchases should be closed within 6 months of the month in which the contracting officer receives evidence of physical completion of the contract." The office administering the contract is responsible for initiating administrative closeout of the contract. Contract files should be reviewed, and all unnecessary documentation should be removed from the files. The status of funds obligated for the contract should be reviewed to determine any excess funds.

## Furnace Rehabilitation

The Center authorized a contractor up to $1.2 million for maintenance and rebuilding of a furnace used for the Program. The funds for this project were included in the CY 1990 contract and were provided from the Transaction Fund. Although the Act requires expenditures from the Transaction Fund to be included in the Annual Materials Plan submitted to Congress for review and approval, the Center did not report that use of funds to Congress.

During the negotiations for the CY 1990 contract, the contractor stated that the major maintenance expense for the furnace was necessary due to the normal wear and tear over 6 years of operation on the Government upgrade contracts. The funds provided for the major repairs of the furnace were in addition to furnace maintenance and operation costs and depreciation that were included in cost figures used to compute upgrade contracts. Using financial data in the audit reports on cost and pricing data issued by the Inspector General, GSA, and the Defense Contract Audit Agency (Appendix B) and data submitted by the contractor to support the unit price proposals for CYs 1987 and 1990, we determined that at least $926,000 for furnace maintenance and operation had been included in the cost data for those 2 years. The auditors could not determine the total amount charged for furnace maintenance and operation for the other years because the contract files did not contain sufficient information. However, the auditors determined that the contract unit prices were based on the same cost elements for each contract year. The detailed breakdown of the cost elements was not available to audit. Based on the detailed cost data that were available for the 2 CYs and the cost elements used by the contractor, we concluded that the contractor received compensation during the first 7 years of the Program to do the major maintenance and rebuilding of the furnace. The furnace required the maintenance and rebuilding as a result of normal usage. Since the contractor considered these items of expense in the preparation of the unit price when bidding on the contract, the reimbursement of $1.2 million for the furnace maintenance was not proper and should not have been paid.

The Act authorizes the use of the Transaction Fund to encourage the development of domestic sources by contracting with domestic facilities to process or refine critical and strategic materials into a form more suitable for use in support of national security. The Act also requires that the proposed use of the Transaction Fund for development purposes be included in the Annual Material Plan submitted to Congress. The use of $1.2 million from the

Transaction Fund was not reported in the Annual Materials Plan. We believe that the use of the funds should be reported to the Congress as required by the Act.

## Cost Accounting Standards

Compliance with CAS is not required unless a contractor is doing business with DoD. The accounting systems of the two contractors involved in the Program did not have to comply with CAS until 1988. The ferroalloy upgrade contracts were the only DoD contracts held by the two Defense contractors. In its audits of the proposed costs for the CY 1990 contracts, Defense Contract Audit Agency reports stated that neither contractors' accounting systems was in compliance with CAS, but that the accounting systems did provide sufficient data to negotiate final contract costs. During contract negotiations for upgrade services in CY 1990, with options for CYs 1991 and 1992, it was agreed that the Center would pay up to $120,000 to each contractor to bring their respective accounting systems into compliance with CAS. Funds from the Transaction Fund would be used to pay for incurred costs. A separate line item was included in the CY 1990 contracts to pay up to $120,000 to the contractors. However, because neither contractor brought its accounting system into compliance with CAS, neither contractor was paid the $120,000.

When the Defense Contract Audit Agency reported on its audits of the proposed costs for CYs 1993 and 1994 contracts, it again pointed out that the contractors' accounting systems were not in compliance with CAS. After issuance of those reports, the Center allowed each contractor to include $250,000 as indirect costs within the costs for the CYs 1993 and 1994 Program unit prices to meet CAS requirements. By including those costs as indirect costs in the unit prices, the Government will pay the contractors even if they do not bring their accounting systems into compliance with CAS. In our opinion, the reimbursement to the contractors for changing their accounting systems in the last 2 years of the Program is not warranted and does not reflect prudent management of scarce resources. In Audit Report No. 6381-92T21000019-446, "Report on the Audit of Proposal for Initial Pricing Under RFP [Request for Proposal] No. DLA300-92-R-0065," August 21, 1992, the Defense Contract Audit Agency questioned the cost-effectiveness of having one of the contractors change its accounting system when the Program is scheduled to be terminated in 1994. The $250,000 should be deleted from the CYs 1993 and 1994 contracts and new unit prices should be computed. The Center should initiate action to expeditiously waive the requirement for the contractor to comply with CAS.

## Contract Closeouts

The Center had not closed the six completed contracts for the Program as required by FAR part 4.804.1. The contract files did not contain complete

documentation on ore shipments to the contractor, ferroalloy shipments to the Stockpile, disposal contracts, and test reports. Also, some of the documentation in the files could not be related to a specific contract. Because the contracts had not been closed as they were completed, the Center had no assurance that the data it was reporting to Congress were accurate.

The DLA conducted a management review of the Center's Directorate of Stockpile Contracts, Acquisition Division, during 1990. That review was conducted to assess the efficiency and effectiveness of operations at the Center. The report identified strengths and weaknesses within the Center's Acquisition Division. One reported weakness was that contract files needed to be closed out, as required by FAR part 4.804.1. The Center agreed with the DLA recommendation to close all completed contracts. Shortly after our audit started in June 1992, we found that completed Program contracts had not been closed. We were unable to determine why the Center had not taken the corrective actions agreed to in response to the May 1990 DLA management review report.

## Recommendations, Management Comments, and Audit Responses

**We recommend that the Administrator, Defense National Stockpile Center:**

**1. Report to Congress the expenditure of $1.2 million from the National Defense Stockpile Transaction Fund for the furnace used in the ferroalloy upgrade program.**

**Management Comments.** The then Assistant Secretary of Defense (Production and Logistics), concurred and stated that the Program was identified in the Annual Materials Plan, but the cost to rebuild the furnace was not included. The Assistant Secretary stated that the expenditure of the $1.2 million would be reported to Congress. DLA nonconcurred with the finding on the basis that the Act did not include a requirement to report individual contract actions in the Annual Materials Plan. DLA stated that the $1.2 million was a cost reimbursement under an existing contract and was not a research and development project requiring a report to Congress in the Annual Materials Plan or the annual report. The DLA also stated it would notify Congress in the next report that $1.2 million was expended in 1991. DLA planned to complete this action by January 1994.

**2. Offset the $1.2 million reimbursement for the furnace rebuilding costs against the contract costs.**

**Management Comments.** The then Assistant Secretary of Defense (Production and Logistics) and DLA partially concurred. Both organizations stated that our report was not clear whether the payment of $1.2 million to rebuild the furnace was an overpayment. Final determination of the overpayment would be determined after an audit by the Defense Contract Audit Agency. DLA also replied that the Defense Contract Audit Agency had done an audit at the time

the furnace was rebuilt and did not identify duplicate payments. Also, no post-award audit since that time had disclosed a duplication of payment. The Defense Contract Audit Agency would be requested to audit this transaction for defective cost and pricing data, with an estimated completion date of September 30, 1993.

**Audit Response.** We reviewed the Defense Contract Audit Agency reports referenced by DLA, and we did not reach the same conclusions. The first audit report referred to in the DLA comments discussed the results of an audit requested to determine if the cost estimate to rebuild the furnace was reasonable and if repair costs charged to the Transaction Fund were proper. The Defense Contract Audit Agency would not have discovered duplicative payments in performing an audit with those stated objectives. The post-award audit was done to evaluate contractor compliance with United States Code, title 10, section 2306a and would not have disclosed whether the payments for the rebuilding of the furnace duplicated payments previously made. We accept the proposed alternative action for a Defense Contract Audit Agency review of the transaction.

**3. Initiate action through appropriate channels to expeditiously waive the Federal Acquisition Regulation cost accounting standards provisions in contract DLA300-92-C-0064.**

**Management Comments.** The DLA nonconcurred with the recommendation although it agreed that it was not cost-effective to enforce the CAS requirement on the contractors. The DLA stated that a waiver could not be granted unless the contractor makes an unequivocal refusal to implement CAS. The comments stated that one contractor has not formally refused to comply with CAS, while the other contractor has incurred substantial costs in an effort to comply with CAS.

**Audit Response.** The need for the contractors' accounting systems to be brought into compliance with CAS was identified in CY 1990. Neither the Center nor the contractors satisfied the CAS requirements in CYs 1990, 1991, and 1992. The Center did not properly manage this issue for 4 years. At this late date in the contract, further action by the Center would probably result in added costs. We have to accept the Center's inaction at this point in time.

**4. Renegotiate contracts DLA300-92-C-0064 and DLA300-92-C-00065 to remove the $250,000 in indirect cost allowances pertaining to compliance with the cost accounting standards provision of the Federal Acquisition Regulation.**

**Management Comments.** DLA stated that appropriate action would be taken to recoup the amounts paid to the one contractor that had not complied with the terms of the contract. DLA added that no action could be taken to recoup funds from the other contractor that had complied with the terms of the contract. The collections should be made by December 31, 1993.

**5. Close the completed contracts for the ferroalloy upgrade program in accordance with the provisions of the Federal Acquisition Regulation.**

**Management Comments.** DLA had initiated action to review contract files and begin the contract close-out procedures. DLA estimated that contract close-out would be completed by September 30, 1994. The then Assistant Secretary of Defense (Production and Logistics) stated that it would ensure that DLA complies with applicable provisions of the FAR. The Defense Contract Audit Agency will be asked to audit the contracts.

# Part III - Additional Information

# Appendix A. Summary Of Ferroalloy Upgrade Program [1]

| | | Quantity Received | | Reimbursements To Contractor | | |
|---|---|---|---|---|---|---|
| Year | Ferroalloy | Short Tons | Short Ton Units | Cash | Excess Commodities | Payment In Kind |
| 1984 | Ferromanganese | 24,332 | [2] | | $ 9,476,387 | |
| | Ferrochrome | 50,253 | 3,326,781 | | 22,321,928 | |
| 1985 | Ferromanganese | 46,582 | 3,581,888 | | 19,342,197 | |
| | Ferrochrome | 49,463 | 3,266,250 | | 22,504,460 | |
| 1986 | Ferromanganese | 34,060 | 2,625,266 | | 15,279,050 | |
| | Ferrochrome | 35,212 | 2,303,550 | | 17,599,125 | |
| 1987 | Ferromanganese | 52,245 | 4,001,944 | | 24,170,106 | |
| | Ferrochrome | 57,776 | 3,793,505 | | 28,830,640 | |
| 1988 | Ferromanganese | 55,007 | 4,224,091 | $ 7,914,838 | 19,105,996 | |
| | Ferrochrome | 45,758 | 2,946,228 | 2,831,201 | 23,823,611 | |
| 1989 | Ferromanganese | 56,152 | 4,311,427 | 16,291,727 | 10,581,788 | |
| | Ferrochrome | 51,742 | 3,350,122 | 3,727,153 | 27,753,374 | |
| 1990 | Ferromanganese | 74,143 | 5,693,228 | 38,827,814 | | |
| | Ferrochrome | 47,268 | 3,095,543 | 30,890,424 | | |
| 1991 | Ferromanganese | 74,753 | 5,740,782 | 30,655,551 | 9,571,159 | |
| | Ferrochrome | 46,933 | 3,106,086 | 25,520,081 | 5,471,412 | |
| 1992[3] | Ferromanganese | 39,331 | 3,026,155 | | 19,317,079 | $4,134,827 |
| | Ferrochrome | 29,613 | 1,957,513 | | 18,637,187 | 2,460,252 |
| | Totals | 870,623 | 60,350,359 | $156,658,789 | $293,785,499 | $6,595,079 |

[1] The figures are based on the auditors' analyses of receiving reports, disposal contracts, and cash payment vouchers Center personnel made available.

[2] Receiving reports did not show short ton units received, only short tons received. Chemical analyses were not available to compute short ton units.

[3] Data through July 30, 1992.

# Appendix B. Audits of Proposed Cost and Pricing Data

| Chromite Upgrade | | | |
|---|---|---|---|
| Organization | Report Number (Type) | Report Date | Contract Years |
| GSA | A60517/d/4/x6329 (Pre-award) | July 28, 1986 | 1987, 1988 |
| GSA | ]A60624/d/4/x6417 (Revised Costs) | Sept. 26, 1986 | 1987, 1988 |
| DCAA* | 1101-9S210049-9-399 (Pre-award) | July 6, 1989 | 1990, 1991 |
| DCAA | 1101-91S16900030-1-203 (Direct Costs/Furnace Rehabilitation) | Feb. 22, 1991 | 1990 |
| DCAA | 1101-91S42010003-1-577 (Post-ward) | Aug. 19, 1991 | 1990, 1991 |
| DCAA | 1101-92S21000052-2-547 (Proposal) | Aug. 7, 1992 | 1993, 1994 |

| Manganese Upgrade | | | |
|---|---|---|---|
| Organization | Report Number (Type) | Report Date | Contract Years |
| GSA | A60505/d/3/x6401 (Pre-award) | Sept. 15, 1986 | 1987, 1998 |
| GSA | A60505/d/3/x6401 (Revised Costs) | Mar. 5, 1987 | 1987, 1988 |
| GSA | A70248/d/3/x7209 (Pre-award) (Cost Of Money) | Mar. 23, 1987 | 1987, 1988 |
| DCAA | 6381-9B210037-438 (Proposal) | July 18, 1989 | 1990, 1991 |
| DCAA | 6381-90B42020012-158 (Post-award) | Feb. 5, 1991 | 1990, 1991 |
| DCAA | 6381-92T21000019-446 (Proposal) | Aug 21, 1992 | 1993, 1994 |

* DCAA - Defense Contract Audit Agency

# Appendix C. Other Matters Of Interest

## Ferroalloy Specifications

The specifications for ferrochromium and ferromanganese were in the June 1983 solicitations sent to prospective bidders on contracts for the Program. The specification for ferrochromium was changed on August 22, 1983, by an amendment to the solicitation. The change to the specification increased the amount of carbon that was allowed to be in the ferrochromium and lowered the maximum weight of ferrochromium lumps from 150 pounds to 75 pounds. The specification also changed the size of the sieve opening for measuring the amount of fines that would be acceptable. Fines are very small or crushed ferroalloy particles. The amended specifications for ferrochromium were in the Program contract signed on December 30, 1983.

The ferrochromium contractor experienced problems in meeting the contract specification. After discussion with the contractor, GSA issued a July 25, 1984, addendum to the specifications; however, the contract was not amended to include the addendum. The addendum to the specification eliminated the requirement that ferrochromium lumps needed to be visibly free of pores to be acceptable. The addendum provided that ferrochromium lumps would not be rejected if visible holes or pores were a result of a furnace cool-down. Also, the addendum provided that a set of three photographs would be used as a guide by Government quality assurance personnel to determine whether ferrochromium would be accepted or rejected. The addendum stated that copies of the photographs would be available from the contracting officer. We asked for copies of those photographs; however, the contracting officer did not have copies of the photographs and could not find copies at the Center.

The specification with the addendum was in the solicitations sent to prospective contractors for the CY 1985 ferrochromium upgrade and was in the contract effective January 1, 1985. The contractor could not produce ferrochromium to that standard in CY 1985. The contract was amended in September 1985 to change the criteria from using the photographs to determine acceptance or rejection of ferrochromium lumps to using three samples of ferrochromium. The 1985 amendment provided that the samples would be available from the contracting officer. The revised specification for ferrochromium was in each contract awarded after 1985.

The auditors asked to see the three samples of ferrochromium used by quality assurance personnel to determine whether the ferrochromium received from the contractor met contract specifications. The contracting officer did not have the samples and could not find the samples at the Center. The contracting officer told the auditors that quality assurance personnel were fully educated in the specifications and did not need the samples to determine whether the ferrochromium lumps should be accepted or rejected.

# Evaluation Factor

The solicitations sent to prospective contractors specified the amount of chromite and manganese ores that would be upgraded to ferroalloys during the proposed contract period. Also, the solicitations listed the estimated amounts of the ores, the estimated quantity of ore and other elements in each pile of ore, and the locations of the ore piles. The amount of ore in a pile had to be known to compute the estimated amount of ferroalloy that could be produced (estimated yield). The solicitation identified one or more piles of ore as a group. To determine the price to be charged for upgrading services, the Center allowed prospective contractors to use any one or combination of ore groups, as long as the total amount of ore in the groups did not exceed the amount of ore to be upgraded. As a result, during the first 2 years of the Program, prospective contractors bid on different ore groups. Bid evaluation, therefore, was difficult because no common basis existed for determining which contractor's bid provided the best price to the Government. To compensate for the differences caused by this problem, GSA used evaluation factors applied to each bid price to determine which contractor would provide the upgrade services at the best price to the Government. The results of applying the evaluation factor to the bids received on the CY 1984 contracts are in the table below.

Evaluation of Bids

(Chromite Ore)

| Bidder | Ore Groups | Bid Price Per Unit | Price Per Unit With Evaluation Factor |
|---|---|---|---|
| 1 | A,B,D,E,F | $ 6.81 | $ 7.567 |
| 2 | B,E,G | 6.77 | 7.717 |
| 3 | G | 8.71 | 11.165 |

The contract to upgrade chromite ore was awarded to Bidder 1 because the price per unit was more favorable to the Government after the evaluation factor was applied to the basic bids.

The auditors attempted to determine the validity of the evaluation factors used in CY 1984; however, contract files did not contain sufficient data to allow the auditors to make the determination. The auditors noted that the evaluation factor was similar to one suggested by the bidder who was awarded the initial contract to upgrade chromite ore. It is our opinion that the use of the evaluation factors may have deterred prospective contractors from bidding on solicitations requested after CY 1984.

# Internal Controls

The audit showed that the Center implemented the Federal Managers' Financial Integrity Act of 1982 as it pertained to the Program in 1991. The implementation covered the functions and operations of the Contracting Division of the Center, the organization that administered the Program. Contracting Division personnel made an internal management control program review as prescribed by DLA Regulation No. 5010.4, "Internal Management Control Program," October 12, 1990. Contracting Division personnel identified two internal management control objectives for the execution and administration of acquisition contracts. The objectives were to ensure acquisition contracts were executed and completed in accordance with individual contract requirements and specifications and to close all contract files in a timely manner. Center personnel did not test the minimal controls established during the review to determine whether the control objectives were being achieved. However, Center personnel reported to DLA that acquisition contracts were executed and completed properly and that contract files were not closed in a timely manner. Center personnel used their own judgment to determine that contracts were executed and completed in accordance with contract requirements and specifications.

The Contracting Division personnel could not determine whether Program contracts had been completed in accordance with contract requirements and specifications. Personnel throughout the Center were responsible for overseeing the various requirements of the Program contracts. For example, the Quality Assurance Division was responsible for determining that the ferroalloys received from the contractors met contract specifications. The Stockpile Storage Division was responsible for ensuring that the ores shipped to the contractors were taken from the correct locations in the correct amounts. The same organization was responsible for the receipt and storage of the ferroalloys. The Acquisition Branch was responsible for negotiating the contracts and overall management of the contracts. No Center official had been made responsible to evaluate the results of the work done by the various offices of the Center to determine whether the contracts were executed and completed in accordance with contract requirements and specifications.

We believe the lack of internal management controls contributed to the conditions discussed in Finding B in Part II of this report. The report contains no recommendations to correct internal control deficiencies because the contracts will be completed shortly.

# Appendix D. Summary of Potential Benefits Resulting from Audit

| Recommendation Reference | Description of Benefit | Amount and/or Type of Benefit |
|---|---|---|
| A. | Program Results. Repeals section 3205 of Public Law 99-661 to terminate the ferroalloy upgrade program. | Nonmonetary. |
| B.1. | Compliance. Ensures compliance with public law requirement to report expenditure of $1.2 million from the National Defense Stockpile Transaction Fund to Congress. | Nonmonetary. |
| B.2. | Economy and Efficiency. Will reduce the value of excess commodities and payments in kind to be transferred from the National Defense Stockpile to one contractor. | Questioned costs of $1.2 million. |
| B.3. | Compliance and Economy and Efficiency. Will waive the requirement to bring the contractors' accounting systems into compliance with cost accounting standards. | Nonmonetary. |
| B.4. | Compliance and Economy and Efficiency. Will reduce price per short ton unit of ferroalloy returned to the National Defense Stockpile. | Questioned costs. Avoids the incurrence of costs totaling about $250,000. |
| B.5. | Compliance and Internal Control. Ensures compliance with the Federal Acquisition Regulation to close out completed contracts and determines whether the contractors produced the ferroalloy for which they were reimbursed. | Nonmonetary. |

# Appendix E. Report Distribution

## Office of the Secretary of Defense

Assistant Secretary of Defense (Economic Security)
Assistant Secretary of Defense (Public Affairs)
Comptroller of the Department of Defense
Director of Defense Procurement

## Department of the Army

Auditor General, U.S. Army Audit Agency

## Department of the Navy

Auditor General, Naval Audit Service

## Department of the Air Force

Auditor General, U.S. Air Force Audit Agency

## Defense Agency

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
  Administrator, Defense National Stockpile Center
Inspector General, Defense Intelligence Agency
Inspector General, National Security Agency
Director, Defense Logistics Studies Information Exchange

## Non-DoD Organizations

Office of Federal Procurement Policy, Cost Accounting Standards Board
Office of Management and Budget
U.S. General Accounting Office, National Security and International Affairs Division, Technical Information Center

## Non-DoD Organizations (Cont'd)

Chairman and Ranking Minority Member of Each of the Following Congressional Committees and Subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Subcommittee on Defense Industry and Technology, Committee on Armed Services
Senate Subcommittee on Readiness, Sustainability, and Support, Committee on Armed Services
Senate Committee on Budget
Senate Committee on Governmental Affairs
Senate Committee on Energy and Natural Resources
Senate Subcommittee on Mineral Resources Development and Production, Committee on Energy and Natural Resources
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations.
House Committee on Armed Services
House Subcommittee on Readiness, Committee on Armed Services
House Subcommittee on Military Acquisition, Committee on Armed Services
House Committee on Natural Resources

# Part IV - Management Comments

# Assistant Secretary of Defense (Production and Logistics)

PRODUCTION AND LOGISTICS

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, DC 20301-8000

8 SEP 1993

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Audit of the Ferroally Upgrade Program
(Project No. 2RA-5002)

I have enclosed the OASD(P&L) comments on the report of your audit of the DNSC Ferroalloy Upgrade Program. I appreciate the contribution your staff has made to our oversight of this program. The Director, Defense Logistics Agency, has been tasked to implement the corrective actions recommended in the report.

David J. Berteau
Principal Deputy

Attachment

**Audit Report on Requirements for and Administration of the Ferroalloy Upgrade Program**

# Finding A.

## Ferroalloy Upgrade Program Requirements

The Center awarded two contracts to upgrade chromate and manganese ores in CYs 1993 and 1994, even though both ferroalloys were excess to Stockpile requirements. The contracts were awarded because Public Law 99-661, the DOD Authorization Act for FY 1987, directed that the Program continue through FY 1993 and specified the minimum short tons of each ferroalloy to be placed in the Stockpile through FY 1993. Also, Public Law 99-661 provided that when the minimum quantity was not met, the deficiency would be added to the next fiscal year's minimum quantity. The cost to the Government, in terms of commodities transferred or payments in kind, could be reduced by about $63 million by terminating the Program without endangerment to national security.

**OSD Response:** Concur in part. We support termination of the program. It is wasteful and does not contribute to national security requirements. In the past, OSD has attempted to have this program repealed. Congress declined to do so. Therefore, termination of this program is dependent on Congressional action.

In addition, if DOD terminates the program, the savings may be substantially less than the $63 million portrayed in the report. The DODIG estimate does not take into account the costs of terminating a 10-year program in its last year of existence and the fact that there is an undelivered balance of $71 million in the upgrade contracts that will substantially reduce the recoverable balance.

### Finding B. Contract Administration

The Center did not adequately administer the ferroalloy upgrade contracts or close out completed contracts. This condition occurred because the Center did not follow procedures established in the FAR when awarding and administering the ferroalloy upgrade contracts and did not ensure that funds were used as prescribed in the Strategic and Critical Materials Stock Piling Act. As a result, an expenditure of $1.2 million was improperly made from the National Defense Stockpile Transaction Fund (Transaction Fund) before it was reported to Congress in the Annual Materials Plan for approval as required by the Act. The expenditure reimbursed a Program contractor, as a direct charge, the cost of rebuilding a furnace that was included as furnace maintenance and operation costs and depreciation in the unit prices paid in the normal performance of the contract. In addition, the Center allowed the two contractors to include $250,000 each in indirect costs to make their accounting systems comply with cost accounting standards (CAS) in the CY 1993 and 1994 contracts. We also found that Program data reported to Congress was not reconcilable with documentation in the contract files.

**OSD Response**: Concur. Although DLA identified the ferroalloy upgrade project in the Annual Materials Plan (AMP), the cost of rebuilding the furnace was not reflected in in the Plan.

## Recommendations for Corrective Action

**A.1.** Include a proposal in the Department of Defense Legislative Program to repeal _ 3205 of Public Law 99-661, which will terminate the requirement to convert chromium and manganese held in the National Defense Stockpile into high carbon ferroalloys.

**OSD Response**: Concur In Part. In the past, OASD(P&L) has proposed legislation to repeal _ 3205 of Public Law 99-661. As the FY 94 DOD Legislative Program has already been submitted to Congress, the proposal can not be resubmitted this year. The program will be completed before there is an opportunity to submit remedial legislation.

**A.2.** Issue a stop order preliminary to eventual termination of contracts DLA300-92-C-0064 and DLA300-92-C-0065. The ferroalloy upgrade contracts should be terminated at the earliest possible time commensurate with the legal authority and necessary phase down actions of work in process.

**OSD Response**: Concur In Part. DOD should issue stop work orders and terminate these contracts at the earliest possible time if these

actions will result in a lower cost to the government after taking into account the termination costs discussed in the OSD Response to finding A.

**B.1.** Report to Congress the expenditure of $1.2 million from the National Defense Stockpile Transaction Fund for the furnace used in the ferroalloy upgrade program.

**OSD Response**: Concur. We will take action to advise Congress of this expenditure from the Transaction Fund.

**B.2.** Offset the $1.2 million reimbursement for the furnace rebuild costs against the contract termination costs discussed in Finding A.

**OSD Response**: Concur in part. It is not clear from this report that the contractor was over compensated for rebuilding the furnace. The extent to which this is true should be determined by the contracting officer with the assistance, if necessary, of a DCAA audit. After we determine the extent of over-payment, we can fashion an appropriate method of repayment. See our response to Recommendation B.5 below.

**B.3.** Initiate action through appropriate channels to expeditiously waive the Federal Acquisition Regulation cost accounting standards provisions in contracts DLA300-92-C-0064 and DLA300-92-C-0065.

**OSD Response**: Concur in part. DNSC has asked the Director of the Defense Logistics Agency to examine the issue and make a determination as to whether the facts warrant a CAS waiver. If this is not the case, the indirect cost charges will remain.

**B.4.** Re-negotiate contracts DLA300-92-C-0064 and DLA300-92-C-0065 to remove the $250,000 in indirect cost allowances pertaining to compliance with the cost accounting standards provision of the Federal Acquisition Regulation.

**OSD Response**: Concur in part. See response to recommendation B.3 above.

**B.5.** Close the completed contracts for the ferroalloy upgrade program in accordance with the provisions of the Federal Acquisition Regulation.

**OSD Response**: Concur. We will take action to insure that DLA complies with applicable provisions of the FAR. This will require *inter alia*, that DCAA audit the furnace rebuild contract and make a determination as to the appropriateness of the charges.

# Defense Logistics Agency

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6100

IN REPLY REFER TO DLA-CI

22 JUN 1993

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DOD
READINESS AND OPERATIONAL SUPPORT DIRECTORATE

SUBJECT: Draft Audit Report on the Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

This is in response to your 29 April 1993 request.

JACQUELINE G. BRYANT
Chief, Internal Review Division
Office of Comptroller

8 Encls
w/att

cc:
MMS
DNSC

FORMAT 1 OF 8

TYPE OF REPORT: AUDIT DATE OF POSITION: 21 JUNE 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

FINDING A: FERROALLOY UPGRADE PROGRAM REQUIREMENTS. The cost to the Government, in terms of commodities transferred or payments in kind, could be reduced by about $63 million by terminating the Program without endangerment to national security.

DLA COMMENTS: **Partially Concur.** We agree that the program could be terminated without endangering national security. In fact, the Department of Defense has tried in the past to have this program repealed. Congress declined to do so. Accordingly, unless Congress repeals the requirement, we cannot terminate for convenience.

If the program could be terminated, the resultant savings may be substantially less than the $63 million estimated by the DoDIG. The numbers in the report fail to take into account the costs of terminating a ten-year program in the last year of its existence or all the costs of termination for convenience outlined in FAR Part 49. Moreover, as of 31 May 1993, the approximate undelivered balance under the upgrade contracts is $71 million. It is doubtful that legislation would be forthcoming until October or November 1993 when the next DoD authorization act is passed. That would also substantially reduce the recoverable balance

INTERNAL MANAGEMENT CONTROL WEAKNESS:
( ) Nonconcur (Rational must be documented and maintained with your copy of the response)
(x) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response )
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance

ACTION OFFICER: T Frank Taylor/DNSC-DI/607-3204
PSE REVIEW/APPROVAL: James J. Grady, Jr., Executive Director, Supply Management, MMS, x44735

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

FORMAT 2 OF 8

TYPE OF REPORT: AUDIT DATE OF POSITION: 21 JUNE 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

RECOMMENDATION A.2: Recommend that the Administrator, Defense National Stockpile Center, issue a stop order preliminary to eventual termination of contracts DLA300-92-C-0064 and DLA300-92-C-0065. The ferroalloy update contracts should be terminated at the earliest possible time commensurate with the legal authority and necessary phase down actions of work in process. Deleted

DLA COMMENTS: **Nonconcur**. A stop-work order is intended as a short-term measure designed to mitigate cost incurrence in the face of anticipated contract requirement changes pending a Government determination to proceed or to terminate. The contract clause calls for work stoppage of no more than 90 days, after which a supplemental agreement must be negotiated or the contract terminated. The premature issuance of a stop-work order is a questionable business judgment that could potentially lead to increased rather than decreased costs, if legislation is not forthcoming and DLA were forced to rescind the order, absorb the costs of idling, and reactivating the furnace. DLA will carefully monitor the progress of repeal legislation if initiated by the Office of the Secretary of Defense. When the outcome of that legislation is more certain, the appropriateness of a stop-work order will be re-evaluated

DISPOSITION:
(x) Action is Considered Complete
( ) Action is ongoing. Estimated Completion Date:

INTERNAL MANAGEMENT CONTROL WEAKNESS:
(x) Nonconcur (Rational must be documented and maintained with your copy of the response)
( ) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance

ACTION OFFICER: T. Frank Taylor/DNSC-DI/607-3204
PSE REVIEW/APPROVAL: James J. Grady, Jr., Executive Director, Supply Management, MMS, x44739

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

FORMAT 3 OF 8

TYPE OF REPORT: AUDIT DATE OF POSITION: 21 JUNE 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

FINDING B: CONTRACT ADMINISTRATION An expenditure of $1.2 million was improperly made from the National Defense Stockpile Transaction Fund (Transaction Fund) before it was reported to Congress in the Annual Materials Plan for approval as required by the Strategic and Critical Materials Stock Piling Act. Program data reported to Congress was not reconcilable with documentation in the contract files.

DLA COMMENTS: **Nonconcur.** There is no requirement in the Strategic and Critical Materials Stock Piling Act to report individual contract actions or transactions in the Annual Materials Plan (AMP) The Annual Materials Plan required by section 11(b) of the Strategic and Critical Materials Stock Piling Act is a summary of major acquisition and disposal actions planned for the next fiscal year It does not, and is not required to, list past individual contract actions or expenditures. Reimbursing a contractor for an expense deemed proper under an existing contract would not be identified in the AMP.

The $1.2 million was a cost reimbursement under an existing contract. It was not a research and development project requiring a report to Congress under either the AMP (section 11(b)) or the annual report (section 11(a)) requirements of the Strategic and Critical Materials Stock Piling Act.

INTERNAL MANAGEMENT CONTROL WEAKNESS:
(x) Nonconcur (Rational must be documented and maintained with your copy of the response)
( ) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: T. Frank Taylor/DNSC-DI/607-3204
PSE REVIEW/APPROVAL: James J. Grady, Jr., Executive Management, Supply Management, MMS, x44735

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

FORMAT 4 OF 8

TYPE OF REPORT: AUDIT DATE OF POSITION: 21 JUNE 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No 2RA-5002)

RECOMMENDATION B.1: Recommend that the Administrator, Defense National Stockpile Center, report to Congress the expenditure of $1.2 million from the National Defense Stockpile Transaction Fund for the furnace used in the ferroalloy upgrade program.

DLA COMMENTS: **Concur.** The Strategic and Critical Materials Report to the Congress on the operations of the National Defense Stockpile includes the total expenditures against the upgrade contracts. Since this is a continuing table, DNSC will include a footnote in the next report that the $1.2 million was expended in 1991 to rebuild the furnace.

DISPOSITION:
( ) Action is Considered Complete
(x) Action is ongoing. Estimated Completion Date: January 1994

INTERNAL MANAGEMENT CONTROL WEAKNESS:
( ) Nonconcur (Rational must be documented and maintained with your copy of the response)
(x) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: T. Frank Taylor/DNSC-DI/607-3204
PSE REVIEW/APPROVAL: James J. Grady, Jr., Executive Director, Supply Management, MMS, x44735

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

FORMAT 5 OF 8

TYPE OF REPORT: AUDIT DATE OF POSITION: 21 JUNE 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

RECOMMENDATION B.2: Recommend that the Administrator, Defense National Stockpile Center, offset the $1.2 million reimbursement for the furnace rebuild costs against the contract termination costs discussed in Finding A.

DLA COMMENTS: **Partially Concur.** DLA did not intend to provide any duplicate payment for furnace repairs. At the time of the calendar year 1990 contract negotiations, DLA relied on the contractors assertions that these were extraordinary costs and the routine prior year allowances for furnace maintenance did not cover the rebuild of the furnace. Since that furnace had been and would continue to be used exclusively for a Government contract, those costs were properly allocable. At that time there was a DCAA audit which did not identify any duplication between the $1.2 million line item and other furnace repair cost elements. Since that time, no post award audit has disclosed a duplication.

**Proposed Alternative Action.** To insure that there was no overpayment, DLA will request DCAA to specifically audit this transaction for defective cost and pricing data.

DISPOSITION:
( ) Action is Considered Complete
(x) Action is ongoing Estimated Completion Date: **30 September 1993**

INTERNAL MANAGEMENT CONTROL WEAKNESS:
( ) Nonconcur (Rational must be documented and maintained with your copy of the response)
(x) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: T. Frank Taylor/DNSC-DI/607-3204
PSE REVIEW/APPROVAL: James J. Grady, Jr., Executive Director, Supply Management, MMS, x44735

DLA APPROVAL: Helen T McCoy, Deputy Comptroller

FORMAT 8 OF 8

TYPE OF REPORT: AUDIT DATE OF POSITION: 21 JUNE 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

RECOMMENDATION B.5: Recommend that the Administrator, Defense National Stockpile Center, close the completed contracts for the ferroalloy upgrade program in accordance with the provisions of the Federal Acquisition Regulation.

DLA COMMENTS: **Concur.** Action has been initiated to review the contract files and begin contract close-out procedures.

DISPOSITION:
( ) Action is Considered Complete
(x) Action is ongoing. Estimated Completion Date: **30 September 1994**

INTERNAL MANAGEMENT CONTROL WEAKNESS:
( ) Nonconcur (Rational must be documented and maintained with your copy of the response)
(x) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: T. Frank Taylor/DNSC-DI/607-3204
PSE REVIEW/APPROVAL: James J. Grady, Jr., Executive Director, Supply Management, MMS, x44735

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

31 MAY 1993

DNSC-PA

TO: DLA-AQP/Contract Policy Team

SUBJECT: Exemption from Cost Accounting Standards (CAS)

1. This is the tenth year in a legislatively mandated program to upgrade Government-furnished manganese ore and chromite ore into high-carbon ferromanganese and high-carbon ferrochromium.

2. Elkem Metals Company produces the ferromanganese and Macalloy Corporation produces the ferrochromium. Both companies have been awarded these contracts since the beginning of the Program.

3. The legislatively mandated quantity, 576,822 ST of ferro-manganese and 518,500 ST of ferrochromium, will be delivered by June 1994.

4. In accordance with FAR Part 30, the 1989 through 1992 contracts contained CAS. However, no disclosure statement was submitted and CAS compliance was not enforced. During pre-award review, the former DLA-PB made inclusion and enforcement of CAS a condition of award.

5. DCAA audited the initial cost proposals and stated that "the cost-benefit relationship to the government to pay for the accounting system change at this stage of the stockpile program, is not apparent...". The entire cost was questioned.

6. At the request of the Assistant Secretary of Defense (Production and Logistics), the Department of Defense Inspector General Office (DoDIG) audited both ferroalloy contracts. The IG found that "the reimbursement to the contractors for changing their accounting systems in the last 2 years of the Program is not warranted and does not reflect prudent management of scarce resources." Their recommendation was that DNSC should "initiate action through appropriate channels to expeditiously waive the Federal Acquisition Regulation cost accounting standards provisions in contracts DLA300-92-C-0064 and DLA300-92-C-0065."

Attachment 1

Page 2
Exemption from Cost Accounting Standards

7. In compliance with both audit reports, DNSC is formally requesting that the Program be exempt from CAS compliance. This exemption could result in a cost savings to the government of approximately $500,000.

8. If additional information is required, please contact Rozelyn Durant or Daniel McMorrow of my staff on (703) 607-3179.

/S/ OLA M. LEE

OLA M. LEE
Director, Directorate of
Stockpile Contracts

cc: Official File - PA
Reading File - P

Concurrence:

PA Daniel B McMorrow 20 May '93

G [illegible] 5/19/93

DI [illegible] 5/20/93

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DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6100

IN REPLY REFER TO FOI

12 AUG 1993

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE, READINESS AND OPERATIONAL SUPPORT DIRECTORATE

SUBJECT: Draft Audit Report on the Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

This is in response to your 29 April 1993 request. We are providing revised comments to Recommendations B.3 and B.4.

2 Encl

For JACQUELINE G. BRYANT
Chief, Internal Review Office
Office of Comptroller

cc:
MMS
DNSC-DI
AQP

TYPE OF REPORT: AUDIT DATE OF POSITION: 2 Aug 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

RECOMMENDATION B.3: Recommend that the Administrator, Defense National Stockpile Center, initiate action through appropriate channels to waive the Federal Acquisition Regulation cost accounting standards provisions in contracts DLA300-92-C-0064 and DLA300-92-C-0065.

DLA COMMENTS: Nonconcur. Although we agree that it is not cost effective to enforce compliance with the Cost Accounting Standards, at this point there are no grounds under which a waiver can be pursued. The Cost Accounting Standards require an unequivocal refusal by the contractor to implement CAS. Contract DLA300-92-C-0064 (Macalloy Corporation) does not qualify for a waiver since the contractor has not formally refused to comply. On contract DLA300-92-C-0065 (Elkem Metals Company) the contractor has incurred substantial costs in efforts to comply with CAS, therefore, there is no basis on which a waiver can be granted.

DISPOSITION:
( ) Action is Considered Complete
(X) Action is ongoing. Estimated Completion Date:

INTERNAL MANAGEMENT CONTROL WEAKNESS:
(x) Nonconcur (Rational must be documented and maintained with your copy of the response)
( ) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance

ACTION OFFICER: T. Frank Taylor/DNSC-DI/607-3204, 23 Jul 93
PSE REVIEW/APPROVAL: James J. Grady, Jr., Deputy Executive Director (Supply Management), 29 Jul 93
DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

TYPE OF REPORT: AUDIT DATE OF POSITION: 2 Aug 93

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO: Requirements for and Administration of the Ferroalloy Upgrade Program (Project No. 2RA-5002)

RECOMMENDATION B.4: Recommend that the Administrator, Defense National Stockpile Center, renegotiate contracts DLA300-92-C-0064 and DLA300-92-C-0065 to remove the $250,000 in indirect cost allowances pertaining to compliance with the cost accounting standards provision of the Federal Acquisition Regulation.

DLA COMMENTS: **Partially concur.** Appropriate action will be taken to recoup the $250,000 from Macalloy Corporation (DLA300-92-C-0064). No action can be taken to recoup any funds from Elkem Metals Company (DLA300-92-C-0065) since they complied with the terms of the contract.

DISPOSITION:
( ) Action is Considered Complete
(x) Action is ongoing. Estimated Completion Date: 31 December 1993

INTERNAL MANAGEMENT CONTROL WEAKNESS:
( ) Nonconcur (Rational must be documented and maintained with your copy of the response)
(x) Concur; however, weakness is not considered material (Rationale must be documented and maintained with your copy of the response.)
( ) Concur, weakness is material and will be reported in the DLA Annual Statement of Assurance.

ACTION OFFICER: T. Frank Taylor, DNSC-DI/607-3204, 23 July 1993
PSE REVIEW/APPROVAL: James J. Grady, Jr., Deputy Executive Director (Supply Management), 29 July 1993
DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

# Audit Team Members

| | |
|---|---|
| William F. Thomas | Director, Readiness and Operational Support Directorate |
| Harlan M. Geyer | Audit Program Director |
| William C. Lamb | Audit Project Manager |
| George J. Sechiel | Acting Audit Project Manager |
| Anella J. Oliva | Senior Auditor |
| John D. McAulay | Auditor |
| Robert L. Kienitz | Auditor |
| Shibani B. Barot | Auditor |
| Thomas E. Biller | Auditor |
| Nancy C. Cipolla | Editor |
| JoAnn B. Fowler | Administrative Support |