

December 30, 2003



Logistics

Defense Reutilization and Marketing Services Commercial Venture Contracts for Privatization of the DoD Surplus Sales Program (D-2004-037)

This special version of the report has been revised to omit contractor proprietary data.

Department of Defense
Office of the Inspector General

Quality

Integrity

Accountability

Copies

To obtain additional copies of this report, visit the Web site of the Inspector General of the Department of Defense at www.dodig.osd.mil/audit/reports or contact the Secondary Reports Distribution Unit of the Audit Followup and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or fax (703) 604-8932.

Suggestions for Future Audits

To suggest ideas for or to request future audits, contact the Audit Followup and Technical Support Directorate at (703) 604-8940 (DSN 664-8940) or fax (703) 604-8932. Ideas and requests can also be mailed to:

OAIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General of the Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-4704

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@dodig.osd.mil; or by writing to the Defense Hotline, The Pentagon, Washington, DC 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

CCLI	Commercial Control List Item
CV	Commercial Venture
DCIA	Defense Logistics Agency Criminal Investigations Activity
DLA	Defense Logistics Agency
DRMO	Defense Reutilization and Marketing Office
DRMS	Defense Reutilization and Marketing Service
FAR	Federal Acquisition Regulation
IG DoD	Inspector General of the Department of Defense
MLI	Munitions List Item
NAACS	National Association of Aircraft and Communication Suppliers, Incorporated
NSN	National Stock Number



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

December 30, 2003

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY
COMMANDER, DEFENSE REUTILIZATION AND
MARKETING SERVICES

SUBJECT: Report on Defense Reutilization and Marketing Services Commercial
Venture Contracts for Privatization of the DoD Surplus Sales Program
(Report No. D-2004-037)

We are providing this report for review and comment. We performed the audit in response to a congressional request. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Deputy Director, Logistics Operations, Defense Logistics Agency comments were partially responsive. We request additional comments on recommendations B.2.a., B.2.b., and D.3. by February 27, 2004.

If possible, please provide management comments in electronic format (Adobe Acrobat file only) to Audcm@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. Matters considered by management to be exempt from public release should be clearly marked for Inspector General consideration.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324) or Ms. Anella J. Oliva at (703) 604-9323 (DSN 664-9323). See Appendix D for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink that reads "David K. Steensma".

David K. Steensma
Director
Contract Management Directorate

Special Warning

This special version of the report has been revised to omit data that is contractor proprietary.

Office of the Inspector General of the Department of Defense

Report No. D-2004-037

December 30, 2003

(Project No. D2002CH-0030)

Defense Reutilization and Marketing Services Commercial Venture Contracts for Privatization of the DoD Surplus Sales Program

Executive Summary

Who Should Read This Report and Why? Civil service and uniformed logistics personnel who are interested in the privatization of sales of DoD surplus property should read this report. The report discusses the overall performance of the commercial venture program, reutilization of surplus property, end-use certificates for surplus property, controls over noncompetitive sales of surplus property, and payments to a financial advisor.

Background. We performed the audit in response to a request from Representative John M. McHugh. Subsequently, Senator John W. Warner also requested we review the commercial venture contract. The request was based on allegations from a constituent who stated that the Defense Reutilization and Marketing Service (DRMS) commercial venture contract was not cost effective to the Government. The DRMS commercial venture program links Government and private industry for selling DoD surplus property and is structured as a term sales contract awarded under the provisions of the Federal Property Management Regulations. The Federal Acquisition Regulation does not apply to the sales contract. On July 14, 1998, DRMS awarded the first 5-year commercial venture program contract, CCand on June 13, 2001, DRMS awarded a 7-year second commercial venture contract.

Results. The commercial venture program represents a new way of doing business for the DoD but needs some improvements. Inconsistent and questionable data made evaluating the financial results of the commercial venture program difficult. However, available data does show that the financial results improved during the first half of FY 2003. DRMS should establish adequate controls over contractor costs, establish contractor performance metrics that evaluate factors similar to other commercial businesses, and determine whether the commercial venture is achieving desired goals. See finding A for details of the results and recommendations.

The Defense Logistics Agency (DLA) was purchasing new property items to fill requisitions while the same property items, in new or unused condition, were being disposed and sold to the commercial venture contractor. DoD could have avoided costs of about \$9.2 million if property items were used to fill open requirements instead of being disposed and could increase revenues up to \$18.7 million if disposed property items with less than 3 years in inventory were sold back to DoD by the commercial venture contractor before being placed on auction. DLA should implement a standard material recoupment program, require personnel to screen new or unused property for

open requirements, and modify the contract to allow screening property items for DoD demand and resale to DoD. See finding B for details of the results and recommendations.

The Defense Logistics Agency Criminal Investigations Activity experienced significant delays in processing end-use certificates from customers of the commercial venture contractor, and the commercial venture contractor stated that sales of applicable items were impaired and that they were incurring additional costs for storing and handling the unsold items. As a result, DRMS revenue decreased an unknown amount, including approximately \$1.07 million that the contractor attributed to the additional costs, from November 2001 to March 2003. Keeping security concerns in mind, DLA should eliminate the backlog of unprocessed certificates and prevent any future backlogs. See finding C for details of the results and the recommendation.

Although the contractor reduced the amount of noncompetitive and reduced-competition sales to about \$0.2 million for the first half of FY 2003, sales below the market value may occur. As a result, DRMS may receive less revenue from noncompetitive and reduced-competition sales. Therefore, DRMS should monitor the dollar level of these sales for any significant increase and include the sales category in reviews of the commercial venture program. See finding D for details of the results and recommendations.

The commercial venture contractor may continue to pay the financial advisor 2.25 percent of the DRMS share of revenue for all 7 years of the second commercial venture contract rather than the 5 years required by the financial advisor contract. As a result, the financial advisor may receive payments longer than what was agreed, with a possible cost to DRMS of about \$1.13 million. DRMS should require that the contractor stop making payments to the financial advisor effective June 13, 2006, in accordance with the financial advisor contract. See finding E for details of the results and the recommendation.

In response to the concerns of a small business trade organization, we determined that the commercial venture program does not appear to have an adverse effect on small business activity. See Appendix C for additional details.

Management Comments and Audit Response. The Deputy Director, Logistics Operations, Defense Logistics Agency agreed to improve oversight of contractor costs, address contractor metrics in the next solicitation, implement a standard material recoupment program, eliminate the backlog of unprocessed end-use certificates, monitor noncompetitive sales and stop making payments to the financial advisors in 2006. The Deputy Director disagreed with modifying the contract to allow screening of property items for potential resale to DoD, and modifying future solicitations to require oversight to noncompetitive sales. We do not agree that modifying the contract to allow the contractor to screen property for demand and resale to DoD distorts the incentives the contract is built on, and we do not agree that requiring minimum documentation and approval requirements for noncompetitive sales will detract from best business practices. Accordingly, we request the Director, Defense Logistics Agency provide comments on the final report by February 27, 2004. See the Findings section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

Table of Contents

Executive Summary	i
Background	1
Objectives	4
Findings	
A. Financial Results of the Commercial Venture Program	5
B. Disposal of Property Items with Demand Requirements	20
C. Processing of End-Use Certificates	29
D. Controls Over Noncompetitive and Reduced-Competition Sales	32
E. Payments on Financial Advisor Contract	36
Appendixes	
A. Scope and Methodology	38
Management Control Program Review	39
Prior Coverage	40
B. Responses to Issues Raised by a Small Business Trade Organization	41
C. Contractor Perspective on the Commercial Venture Program	45
D. Report Distribution	46
Management Comments	
Defense Logistics Agency	49

Background

We performed this audit as a followon to a prior audit that Representative John M. McHugh requested. The request was based on two issues that Representative McHugh received from a constituent. The first issue related to the Office of Management and Budget Circular No. A-76 public/private competition for providing logistics services at 10 Defense Reutilization and Marketing Offices. The issue was not substantiated in the Inspector General of the Department of Defense (IG DoD) Report No. D-2002-043, "Defense Reutilization and Marketing Service Public/Private Competition," January 25, 2002. The second issue the constituent raised related to the costs of the Defense Reutilization and Marketing Service (DRMS) commercial venture contract. This report addresses that issue in finding A.

In addition, Senator John W. Warner requested that the IG DoD look into allegations concerning the DRMS cost of transporting items to regional centers for demilitarization and the impact that changes in DRMS operations for selling excess property and scrap will have on small businesses. A subsequent meeting with personnel from both Senator Warner's office and the Senate Armed Services Committee resulted in a request to assess the adequacy of the sales contracting method DRMS used for selling DoD surplus property through a contractor. The initial allegations were not substantiated in IG DoD Report No. D-2002-025, "Allegations Concerning Defense Reutilization and Marketing Service Business Practices," December 17, 2001. This report addresses the adequacy of the sales contracting method in both finding A and finding D.

Defense Reutilization and Marketing Service. DRMS is a component of the Defense Logistics Agency (DLA), which provides logistical support for not only peacetime and wartime operations but also emergency preparedness and humanitarian missions. DLA supplies the Services and several civilian agencies with the resources they need for critical missions throughout the world.

Any property that the Services determine exceeds their needs is sent to DRMS. Excess property can either be redistributed within DoD or transferred to other Federal agencies. Property not redistributed or transferred is designated surplus. Surplus property can be donated to eligible entities, such as state and local Governments. Any property that remains may be sold to the general public.

DoD Manual 4160.21-M, "Defense Materiel Disposition Manual," August 18, 1997, requires that personal property (including scrap) shall be disposed of in a manner that obtains optimum monetary return to the Government for property sold. The manual also states that DRMS has the primary role of obtaining satisfactory sales results and that DRMS shall employ the most efficient and economical methods of selling personal property.

DRMS Operations. In 1992, DLA directed that DRMS become self-sufficient by balancing sales revenue and overall operating costs. Because the Federal

Government was moving in a new direction and involved in a “reinvention” of Government, DLA had the opportunity to explore various alternative business practices.

The Deputy Secretary of Defense approved the DRMS Enterprise Management business philosophy in February 1996. The philosophy allowed DRMS to selectively privatize its operations and work with industry to incorporate private sector management approaches. Then, in June 1996, DRMS was allowed to explore using the private sector to sell excess DoD material.

Commercial Venture Program

Financial Advisor Contract. DRMS awarded contract number SP4410-97-C-1000 on December 18, 1996, to Kormendi-Gardner Partners. Kormendi-Gardner Partners would serve as a financial advisor to help DRMS explore ways of using the private sector for selling excess DoD property. Kormendi-Gardner Partners provided financial advisory services, which included helping DRMS structure commercial venture transactions. The contract required that Kormendi-Gardner Partners receive 2.25 percent of the net proceeds DRMS received for 5 years from the start of the commercial venture program. The commercial venture contractor, not DRMS, makes the payments to Kormendi-Gardner Partners.

Commercial Venture Program Award. The commercial venture program was awarded as a term sales contract under the provisions of the Federal Property Management Regulations; therefore, the Federal Acquisition Regulation (FAR) does not apply. However, the commercial venture program is actually a net-proceeds-sharing contract, with a residual interest retained by DRMS. The program links DRMS and private industry to sell DoD surplus property and is part of the DoD infrastructure-reduction effort. A key aspect of the program is the intended alignment of financial interests between the private industry contractor and DRMS. The contractor purchases the DoD surplus property from DRMS for a low percentage of the original acquisition value. When the property is sold, DRMS receives a significant percentage of the net proceeds.

Original Commercial Venture Contract. DRMS designated 312 Federal supply classes of property items for the first commercial venture program (CV1). DRMS awarded contract number 97-7005-0002 as a 5-year contract to Levy/Latham, LLC (later SurplusBid.com, Incorporated) on July 14, 1998. Levy/Latham, LLC was required to form a single-purpose Subchapter S Corporation or limited liability company, designated “the Purchaser.” Levy/Latham, LLC formed Levy/Latham Global, LLC (Levy/Latham Global) to meet this requirement. Levy/Latham Global was responsible for purchasing property, managing and disposing of property, and managing the financial affairs including receipts, payments, accounting systems, cash flow management, audits, and cash distributions to Levy/Latham, LLC and DRMS.

Follow-on Commercial Venture Contract. As a follow-on to CV1, DRMS designated an additional 342 Federal supply classes of property items for a second commercial venture contract (CV2). DRMS anticipated that the

contractors for CV1 and CV2 as well as the Federal supply classes would merge into one commercial venture contract upon conclusion of CV1, whether that occurred at the scheduled date or earlier.

On June 13, 2001, DRMS awarded contract number 99-0001-0002 as a 7-year contract to Surplus Acquisition Venture, LLC (Surplus Acquisition Venture). Like Levy/Latham, LLC, Surplus Acquisition Venture was required to set up a separate single-purpose Purchaser. That single-purpose purchaser was Government Liquidation.com, LLC (Government Liquidation).

On April 19, 2001, Government Liquidation entered into an agreement to purchase, for \$*¹, SurplusBid.com, Incorporated and for \$*¹, Levy/Latham Global. As anticipated in the solicitation, Government Liquidation, along with its parent company, Surplus Acquisition Venture, became the sole commercial venture contractor, and the CV1 Federal supply classes were incorporated into the CV2 contract, for a total of 654 Federal supply classes.

Financial Transaction Flow in the Commercial Venture Contracts. DRMS receives income from the commercial venture program two ways.

Initial Contract Payments. At least twice each month, DRMS identifies the property to be sold under the CV2 contract, and Surplus Acquisition Venture buys the property at the established percentages in the CV2 contract, which range from 0.00005 to 0.007066 of the original acquisition cost. For items identified with a National Stock Number (NSN), DRMS obtains the acquisition value recorded for the NSN from centralized Federal procurement records. For other items, the activity disposing of the item provides DRMS with the acquisition value based on the recorded original procurement cost or on the estimated replacement cost. That initial payment is split 97.75 percent to DRMS and 2.25 percent to Kormendi-Gardner Partners, who is the financial advisor. Under CV2, Surplus Acquisition Venture transfers the total purchase price to Government Liquidation, and Government Liquidation distributes the respective shares to DRMS and the financial advisor, as shown in Figure 1.

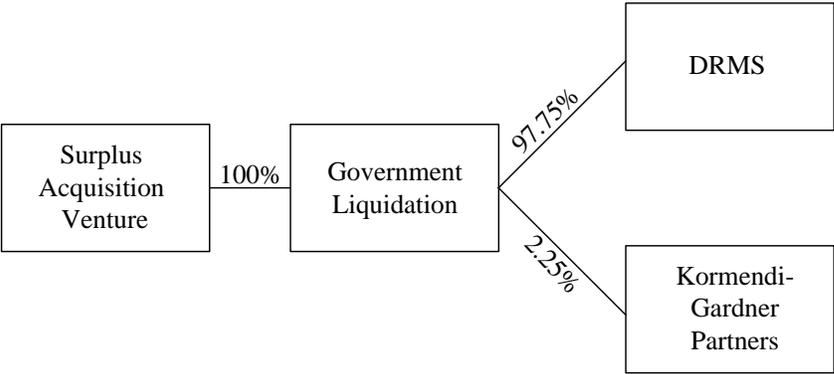


Figure 1. Distribution of the Initial Payment for the Surplus Property

¹ This figure represents contractor proprietary data that has been deleted.

Sale of DoD Surplus Property. DRMS literature generally states that DRMS receives 80 percent of the monthly net proceeds from the sale of property and that the commercial venture contractor receives 20 percent. Government Liquidation sells the property, collects the funds, and pays for all the direct and indirect costs associated with selling the property. Each month, Government Liquidation distributes net proceeds from the sales after costs based on its cash balance, less certain adjustments such as estimated cash needs for the next month. The financial advisor is entitled to 2.25 percent of the DRMS proceeds; therefore, the financial advisor receives 2.25 percent of the DRMS 80 percent, or 1.8 percent of the cash to be distributed. As a result, DRMS actually receives 78.2 percent of the cash to be distributed. Figure 2 shows the distribution of adjusted net proceeds from the commercial venture program. Surplus Acquisition Venture's overall profit is the 20-percent contractor distribution minus the initial payment for the property.

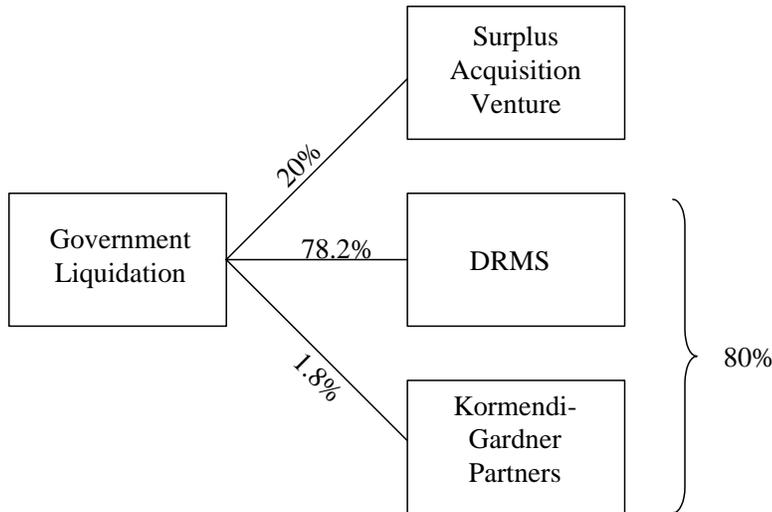


Figure 2. Monthly Distribution of Adjusted Net Proceeds from the Commercial Venture Program

Objectives

Our overall audit objective was to evaluate whether the DRMS commercial venture contracts for privatization of the DoD surplus sales program were providing the best value for DoD. A secondary objective was to evaluate whether privatization of the program had adversely affected small businesses that purchase, sell, and operate military surplus aircraft parts businesses. We also reviewed the management control program as it related to the overall objective. See Appendix A for a discussion of the scope and methodology, our review of the management control program, and prior coverage related to the objectives. See Appendix B for the results of the secondary objective.

A. Financial Results of the Commercial Venture Program

Inconsistent and questionable data made evaluating the financial results of the commercial venture program difficult. Available data show that program costs have increased from \$37.6 million in FY 1997 to \$39.1 million in FY 2002 while the acquisition value of surplus materiel available for disposal decreased from \$5.3 billion to \$1.9 billion. Also, DRMS net profit decreased from \$90.3 million in FY 1997, or 1.71 percent of the acquisition value of materiel, to \$8.3 million, or 0.43 percent of the acquisition value of materiel in FY 2002. Evaluating the program was difficult because controls over contractor costs were limited, contractor selection criteria were ineffective, and performance metrics were inadequate. As a result, to effectively monitor performance of the commercial venture program, contractor costs need to be closely monitored, selection criteria need to be evaluated and revised, and effective performance metrics need to be developed.

Financial Results of the Commercial Venture Program

Inconsistent and questionable data made evaluating the financial results of the commercial venture program difficult. We calculated and compared commercial venture program gross rates of return, costs, and DRMS profit as a percentage of sales and as a percentage of acquisition cost for FY 1997, FY 1998, FY 2001, FY 2002, and FY 2003. DRMS was the source for all pre-commercial-venture figures, including the sales revenues and acquisition value of items sold by DRMS, and of the associated DRMS costs both before and after the start of the commercial venture program. The solicitation for the second commercial venture contract also had sales revenues and associated acquisition values for FY 1997 and FY 1998. DRMS was not able to reconcile significant discrepancies between the solicitation figures and the figures they provided for us. For that reason, we are presenting gross rates of return for FY 1997 and FY 1998 using both sets of figures. However, because the solicitation does not contain any associated DRMS costs, we were not able to use the solicitation figures in our other analyses.

Gross Rates of Return Under CV2. Depending on the source, the CV2 results look comparable to or better than the FY 1997 and FY 1998 results from the point of view of gross rates of return. A gross rate of return is the ratio of the sales proceeds to the original acquisition value of the items sold. The average gross rate of return that DRMS achieved for FY 1997 and FY 1998 was 2.24 percent for CV2 items using the figures DRMS prepared for us, comparable to the *² percent achieved by the CV2 contractor through March 2003. Using the solicitation figures, the CV2 figures were considerably better than the average 1.73 percent for FY 1997 and 1998. Table 1 shows both comparisons with the gross rates of return by fiscal year.

² This figure was calculated using contractor proprietary data and has been deleted.

Table 1. Commercial Venture Program Gross Rates of Return

<u>FY</u>	<u>CV2 Federal Supply Class Items</u>	
	<u>DRMS Figures, Gross Rate of Return (percent)</u>	<u>Solicitation, Gross Rate of Return (percent)</u>
DRMS		
1997	2.42	1.90
1998	2.06	1.55
DRMS Average¹	2.24	1.73
Commercial Venture		
2001 ¹	* ³	
2002	* ³	
1st half 2003	* ³	
Contractor Average²	*³	

¹Last 3 months considered CV2.
²Average percentages based on whole percentages and weighted for partial years.

Commercial Venture Program Costs. While DRMS costs have decreased, overall CV2 program costs were higher than DRMS costs in FY 1997 and FY 1998. In addition, CV2 program costs as a percentage of sales or as a percentage of acquisition value had also increased. However, costs as a percentage of sales and costs as a percentage of acquisition value were improving and all DRMS costs did not directly apply to the CV2 program. Although DRMS personnel stated that segregating costs not related to the CV2 program (managing hazardous material and demilitarization material) was not possible, the same costs were included in both comparisons. Program costs consist of DRMS costs, contractor costs, and proceeds shared with Surplus Acquisition Venture and the financial advisor. Table 2 shows that while DRMS costs have decreased, overall program costs as a percentage of sales or of acquisition value have increased under CV2. However, the CV2 program costs as a percentage of sales declined in FY 2003, and that trend may continue.

³ This figure was calculated using contractor proprietary data and has been deleted.

Table 2. Commercial Venture Program Costs

<u>FY</u>	<u>DRMS Costs (millions)</u>	<u>Contractor Costs (millions)</u>	<u>Proceeds Sharing (millions)</u>	<u>Total Costs (millions)</u>	<u>Costs as Percentage of sales</u>	<u>Costs as Percentage of Acq Value</u>
Prior to CV Program						
1997	\$37.6	\$0	\$0	\$37.6	29.4%	0.71%
1998	33.4	0	0	33.4	30.4%	0.62%
CV2						
2001 ¹	4.8	* ⁴	* ⁴	* ⁴	* ⁴	* ⁴
2002	12.6	* ⁴	* ⁴	* ⁴	* ⁴	* ⁴
2003 ²	10.2	* ⁴	* ⁴	* ⁴	* ⁴	* ⁴

¹3 months costs after CV2 started in June 2001.

²CV2 costs annualized based on first 6 months of FY 2003.

In Table 2 above, the DRMS costs cover more than just the costs related to the commercial venture program. DRMS personnel also told us they had no way of determining what portion of their costs applied to the sale of comparable items before the commercial venture program or of the remaining DRMS expense of running the commercial venture program. Therefore, all of the DRMS costs above are the total costs DRMS reported to us related to sales of all material except scrap and are overstated. In addition, we also calculated the commercial venture program costs completely omitting the overstated DRMS costs from the above analysis for FY 2001 through FY 2003, thus giving the commercial venture program the maximum benefit of the doubt, and costs as a percentage of sales were 72.8 percent, 60.8 percent, and 49.4 percent, respectively. The percentages were still significantly higher than the percentages prior to the commercial venture program.

CV2 Net Profit to DRMS. Figure 3 shows a comparison of DRMS profit from FY 1997 and FY 1998 with the results of the CV2 program in FY 2002 and FY 2003 (data for first 6 months of FY 2003 annualized).

⁴ This figure was calculated using contractor proprietary data and has been deleted.

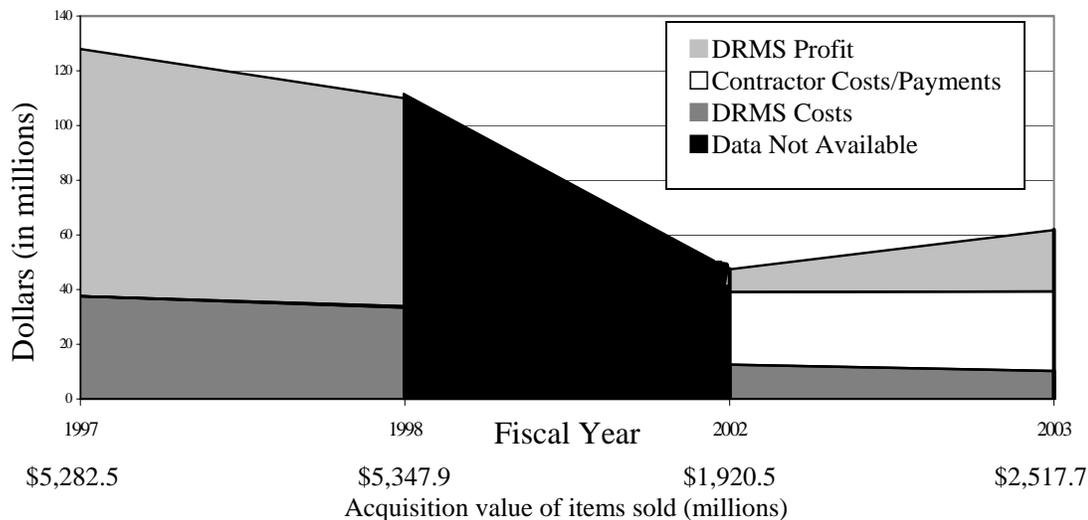


Figure 3. Profits Have Decreased Under the CV2 Program, but the Decline in Quality of Items to Sell and Other Factors Contributed to the Decrease

Table 3 shows the actual numbers underlying the above figure and emphasizes DRMS profit as percentages of sales revenue and acquisition value.

	<u>FY 1997</u>	<u>FY 1998</u>	<u>FY 2002</u>	<u>FY 2003</u>
Acquisition Value of Items Sold	\$5,282.5	\$5,347.9	\$1,920.5	\$1,258.9
DRMS Sales Revenue	127.9	109.9		
Contractor Sales Revenue			* ⁵	* ⁵
Initial Payments from Contractor			* ⁵	* ⁵
DRMS Proceeds Share from Contractor			* ⁵	* ⁵
Other DRMS Proceeds from Contractor			* ⁵	* ⁵
Total DRMS Contract Proceeds			* ⁵	* ⁵
DRMS Costs	37.6	33.4	12.6	5.1
DRMS Net Profit¹	\$90.3	\$76.5	\$8.2	\$11.1
DRMS Net Profit as a Percentage of Sales	70.6%	69.6%	18.9%	37.8%
DRMS Net Profit as a Percentage of Acquisition Value	1.7%	1.4%	0.4%	0.9%

¹DRMS sales revenue minus DRMS costs for FY 1997 and 1998. Total DRMS contract proceeds minus DRMS costs for FY 2002 and 2003.

⁵ This figure was calculated using contractor proprietary data and has been deleted.

Although the DRMS costs above are overstated, the rates of return on acquisition value are still lower than before under the commercial venture program without counting the DRMS costs for the commercial venture years. The FY 2002 and FY 2003 profits would be 1.1 percent and 1.3 percent, respectively, without counting the DRMS costs, and would actually be lower because of the effect of the unknown DRMS costs. These are lower than the above 1.7 percent and 1.4 percent for FY 1997 and FY 1998, which we know are actually higher because the overstated DRMS costs are used in those calculations.

Controls Over Contractor Costs

Applicable Guidance. The CV2 contract was structured as a term sales contract under the provisions of the Federal Property Management Regulation, which does not address contractor costs. Although the FAR does not apply to the sales contract, the commercial venture arrangement has characteristics of a cost reimbursement contract. The Government does not reimburse the contractor for costs, but the contractor is able to deduct costs from sales proceeds in determining the amount to be distributed, of which the DRMS share is 78.2 percent. The result is the same as if the Government reimbursed the contractor for 78.2 percent of costs; therefore, the Government has a similar interest in controlling the contractor costs, as it would have in a cost reimbursement contract. The FAR contains guidance specifically applicable to cost reimbursement contracts, including contractor costs.

Alignment of Financial Incentives. As explained in the background, the alignment of financial incentives can be expected to exert some control over contractor costs. However, the contract also requires that DRMS provide some oversight, and that the oversight cannot be effective if no guidance on reasonable costs exists.

Merger and Acquisition Costs. On April 19, 2001, Government Liquidation entered into an agreement to purchase the parent company of CV1, SurplusBid.com, Incorporated, for \$*⁶ and the CV1 subsidiary, Levy/Latham Global, for \$*⁶. According to the two purchase agreements, the purchase prices were each to be paid in 33 installments. The \$*⁶ paid for SurplusBid.com, Incorporated was payable entirely to the CV1 contractor and included “the assets comprising the surplus sales and marketing business” of SurplusBid.com, Incorporated. The \$*⁶ paid for Levy/Latham Global was split 20 percent to SurplusBid.com, Incorporated, 78.2 percent to DRMS, and 1.8 percent to the financial advisor and included “the assets comprising the surplus sales and marketing business” of Levy/Latham Global. The assets included but were not limited to unsold inventories. The DRMS sales contracting officer approved inclusion of the amounts as direct costs under the CV2 contract in a letter dated June 15, 2001.

⁶ This figure was calculated using contractor proprietary data and has been deleted.

FAR 31.205-27, "Organization Costs," prohibits merger and acquisition costs and states:

. . . expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions . . . are unallowable.

However, because the commercial venture program was awarded as a sales contract that the Federal Property Management Regulation governs, the sales contracting officer allowed the costs to be included as direct costs of the CV2 contract.

The purchase of Levy/Latham Global did not have a net effect on DRMS because DRMS received the same 78.2 percent of the \$*⁷ that it would have received if the \$*⁷ direct cost did not exist. For example, assuming sales were \$10 million and direct costs, including the \$*⁷, were \$6 million, the DRMS 78.2-percent share of the net proceeds of \$4 million would be \$3,128,000. In addition, DRMS would receive 78.2 percent of the \$*⁷, or \$*⁷, for a total of \$*⁷. On the other hand, had the \$*⁷ never been paid, DRMS still would have received \$*⁷ as the 78.2-percent share of the \$6 million in net proceeds.

However, the purchase of SurplusBid.com, Incorporated for \$*⁷ resulted in additional costs of about \$*⁷ to DRMS, which was 78.2 percent of the total amount. For example, if sales were \$10 million and costs were \$7 million, including the \$*⁷, the DRMS 78.2-percent share of the \$3 million net proceeds would be \$2,346,000. Without the \$*⁷ in costs, the DRMS share of the \$*⁷ in net proceeds would be \$*⁷, or \$*⁷ more. Additionally, because DRMS had already shared in the startup costs of CV1 through the costs of the CV1 contract, DRMS shared in \$*⁷ of the same startup costs a second time.

Composition of Recent Contractor Costs. Table 4 shows that for the first full fiscal year of the CV2 contract, FY 2002, the reported contractor costs were about \$*⁷. The two largest categories were payroll and related expenses and the installment payments for the purchase of the CV1 companies or merger and acquisition costs. The "other" category consists of expenditures for items such as outside labor, travel, and normal operating costs.

<u>Type of Cost</u>	<u>Amount (millions)</u>
Payroll, payroll tax, and employee benefits	\$ * ⁷
Merger and acquisition costs	* ⁷
Sales and marketing	* ⁷
Other	* ²
	-
Total	\$*⁷

⁷ This figure represents contractor proprietary data that has been deleted.

Existing Controls. Existing controls over contractor costs were minimal. The contract has no specific guidance on the type of costs or level of allowable costs in different categories. The contract does, however, require that costs are actually incurred for performance of the contract and supported by an invoice or comparable document from the provider.

According to the contract, someone from DRMS or from another Government agency that the sales contracting officer designates is entitled to periodically review compliance with the contract as well as applicable laws and regulations. The DRMS sales contracting officer and personnel from the Defense Contract Audit Agency alternately conduct such reviews. The Defense Contract Audit Agency reviews are limited to procedures agreed upon with the sales contracting officer, rather than their own usual procedures. We do not believe that the reviews have contained adequate examination of costs for reasonableness. Additionally, the sales contracting officer stated that he would have little leverage to declare a cost either improper or excessive.

FAR Applicability to Payroll and Related Expenses. Controls over the largest category of direct costs, payroll related costs, which comprised about *⁸ percent of the contractor costs for FY 2002, would be much more stringent under the FAR. Per Subpart 31.205-6, compensation must be reasonable and must conform to the contractor's established compensation plan. The compensation plan is subject to review by the administrative contracting officer. Government Liquidation's parent company told us they had a compensation plan that is reviewed by the Board of Directors, but the Government has not performed a compensation review. DRMS needs to establish adequate controls over contractor costs for the commercial venture program similar to those in the FAR.

Contractor Selection Criteria

Method for Determining Highest Bid Price. In awarding the CV2 contract, DRMS did not consider contractor costs and, ultimately, the total return to DRMS. According to the solicitation, award would be made to the responsive, responsible bidder that had submitted the highest bid price. The bid price was based solely on what the contractor proposed to pay for the initial payment. Additionally, the bid price depended on estimates of the amounts and types of items that would be made available to the contractor during the contract period.

Results of Bidding and Award. The winning bidder was determined in accordance with the solicitation. DRMS received two responsive, responsible bids on the CV2 contract—one from the existing CV1 contractor, SurplusBid.com, Incorporated, and one from Surplus Acquisition Venture. Surplus Acquisition Venture was awarded the contract because they were considered a responsible bidder and had the higher bid price. The difference between the two bid prices was only \$110,525, which was 3.34 percent of the winning bid price of \$3,310,900.

⁸ This figure represents contractor proprietary data that has been deleted.

Overall Return to DRMS. To obtain the optimum monetary return for the commercial venture program, DRMS had an interest in obtaining a commercial venture contractor that was most likely to have lower costs. As discussed in the Background, the initial purchase price was a minimal amount that DRMS expected to receive from the contractor. DRMS would also receive a significantly higher monthly distribution of funds based on cash balances of Government Liquidation, which in turn were affected by cash outlays to cover costs. Therefore, higher contractor costs would reduce the amount of income DRMS would receive.

DRMS personnel told us that they believed they did not have the option of considering anticipated contractor costs in the award of CV2. They stated that the Federal Property Management Regulation does not allow the use of contractor costs as a criterion for award of sales contracts. The DRMS legal counsel further stated that for years DRMS had been trying to get legislative relief for allowing such a “best-value” approach in sales contracts but without success. In any future commercial venture arrangement for disposal of surplus property, the overall return to the Government should be a paramount concern in accordance with DoD Manual 4160.21-M. Relevant contractor costs should be considered in the award of any contract, and the Government needs to monitor contractor costs and take action if excessive. Therefore, DRMS should prepare a legislative proposal that enables the use of a best-value approach in the award of sales contracts and submit the proposal to Congress.

Contractor Costs. If DRMS had considered contractor costs in the award decision, arriving at a calculated overall return to DRMS, a different decision may have been made. The incumbent contractor had already incurred startup costs of at least \$*⁹ based on having repaid that amount of advances from its parent company, and DRMS is paying SurplusBid.com, Incorporated \$*⁹ of the merger and acquisition costs associated with acquiring SurplusBid.com, Incorporated. That amount is far greater than the \$110,525 separating the bid purchase prices, which, as noted, were based on estimates. A new contractor would be expected to incur startup costs, while an existing contractor would not.

DRMS needs to determine how the selection criteria for the follow-on contract will consider contractor costs and preclude any future payment of merger and acquisition costs.

Commercial Venture Performance Metrics

CV2 Metrics. The CV2 contract contains performance metrics to be reported in quarterly reports from the contractor, which, if not consistently met, allowed either DRMS or the contractor to terminate the contract. The contract requires that the performance metrics calculations begin with the fourth quarterly report after contract award. Specifically, it allows termination by either party if the results of the previous two quarters and the immediately preceding calendar year fail to attain required levels.

⁹ This figure represents contractor proprietary data that has been deleted.

The metrics are based on results from only some of the Federal supply classes sold, 83 of the 654 Federal supply classes. They require the calculation of a “CV [commercial venture] Performance Ratio,” and a “Benchmark Performance Ratio.” The “CV Performance Ratio” is the gross proceeds from sales of 83 designated Federal supply classes divided by the original acquisition value of property sold. For the “Benchmark Performance Ratio,” the CV2 contract lists a desired gross rate of return on acquisition value for each Federal supply class and demilitarization code combination included in the 83 designated items Federal Supply Classes. DRMS established a specific gross rate of return for each combination, which was lower than the DRMS historical rates. The original acquisition cost of items sold in each designated combination is multiplied by the designated rate of return in the CV2 contract. To get the Benchmark Performance Ratio, the results are then added together and divided by the total acquisition value of the designated items sold. The CV2 contract requires that the “CV Performance Ratio” be higher than the “Benchmark Performance Ratio.”

The greatest shortcoming of the CV2 performance metrics, in our opinion, is that no part of the CV2 contract metrics calculations includes contractor costs. Therefore, in the worst case, the contractor could have costs about equal to the proceeds from sales, and DRMS would get little or nothing beyond the initial payment. Under the contract for CV2, such an outcome would not be grounds for DRMS to terminate the arrangement.

Other Factors Unrelated to Performance

Factors Possibly Affecting Results. Various factors beyond the CV2 contractor’s control have probably affected the above results. The first factor is related to the setup of the contract and may be temporary.

Startup Costs. The contractor has emphasized to us that FY 2002 was a “ramp-up” year in the 7-year CV2 contract, and the improved performance in the first 6 months of FY 2003 may be an indication that the ramp-up is nearing completion. Additionally, because the contract is set up so that distributions of proceeds are based on cash balances, capital expenses such as purchases of equipment are totally reflected in the reported costs of the year paid. In later years, as the equipment is still in use and the costs no longer affect distributions, distributions to DRMS results should be high.

Quality of Material. According to figures DRMS provided to us, the percentage of the highest quality material, by acquisition value, decreased from 35.45 percent in FY 1998, before the commercial venture program, to 28.31 percent for FY 2003, under CV2. The percentage of the lowest quality material increased correspondingly from 23.35 percent to 29.67 percent. Such an overall decline in the quality of material could affect the program results.

Events of September 11, 2001. Because the terrorist attacks occurred just before the beginning of FY 2002, and very early in the CV2 performance period, a negative effect on sales would be expected. Specifically, according to the contractor, the terrorist attacks limited “employee and customer access to DoD

facilities and had a negative impact on the marketplace for the disposal of DoD surplus.”

End-Use Certificates. Delays in issuing end-use certificates allowing the purchase of certain items delayed the full start of sales of those items. The contractor also reported that costs increased because of the delay. See finding C for more detail on the issue.

Sales Tax. The contractor’s reported sales do not reflect sales taxes collected, but the reported costs do reflect remittances of the taxes to respective jurisdictions. Because DRMS did not have to collect sales taxes, the contractor is at some disadvantage in comparisons of costs as a percentage of sales. For FY 2002, according to contractor monthly reports, sales taxes were about 2.8 percent of reported sales.

Conclusion

Inconsistent and questionable data made evaluating the financial results of the commercial venture program difficult. Using available data shows that overall commercial venture program costs increased from *¹⁰ percent of original acquisition value in FY 1997 to *¹⁰ percent of acquisition value in FY 2003. In addition, DRMS net profit for the commercial venture program decreased from \$90.3 million in FY 1997 (1.71 percent of acquisition value) to \$8.3 million (0.43 percent of acquisition value) in FY 2002. However, these results improved during the first half of FY 2003, and continued improvement could lead to results as good as or better than FY 1997 results.

DRMS needs to adequately monitor performance of the commercial venture program and consider the overall return to the Government in the selection of future commercial venture contractors. Additionally, DRMS needs to develop more effective contractor performance metrics. Finally, DRMS needs to evaluate the overall effectiveness of the commercial venture program to determine whether it is the best alternative.

Changes to Finding as a Result of Discussions With Contractor

Following the issuance of the draft report, the CV2 contractor brought a number of issues to our attention, and we agreed that the presentation would be fairer if we made certain changes to finding A. We also agreed to include a one-page summary of the CV2 contractor’s perspective on the commercial venture program in Appendix C. An overview of the changes follows.

In the area of financial results, the contractor pointed out that the numbers that DRMS provided for sales revenues and acquisition values of items sold for FY 1997 and FY 1998 did not agree with the same figures as presented in the CV2 solicitation. As a result, DRMS discovered that the numbers they had provided for the draft report were erroneous and provided revised numbers, which

¹⁰ This figure represents contractor proprietary data that has been deleted.

were still different from the solicitation numbers. Because DRMS was unable to reconcile the two sets of numbers, we are presenting gross rates of return based on both sets of numbers in this final report.

Also in the area of financial results, the contractor pointed out inconsistencies in the DRMS costs presented in the draft report. DRMS personnel concluded that they had no way to allocate their costs to the efforts of handling the CV2 items, either before or after the commercial venture program. Therefore, in the final report, we used the cost figures DRMS provided that apply to the sale of all items except scrap. We disclosed the known overstatements of DRMS costs and have adjusted our interpretation accordingly.

Regarding overall presentation, we have included discussion of the alignment of incentives both in this finding and in the background section; minimized discussion of the CV1 results; pointed out certain disadvantages the CV2 contractor had during FY 2002, including the decline in the quality of material; and emphasized the improved results for FY 2003. We have removed discussion of the financial expectations of the commercial venture program. We have also changed our statement about the contractor's compensation plan to state that the contractor reports that it has a plan, although it has still not had any Government review.

Management Comments on the Finding and Audit Response

We received comments on the finding from the Deputy Director, Logistics Operations, DLA. A summary of the comments follows.

Management Comments on the Audit Objectives. DLA disagreed with our use of the expression "best value to the Government" in our audit objectives on the basis that the term is used in the procurement environment as governed by the FAR, while the commercial venture program involves a sales contract governed by the Federal Property Management Regulation. DLA stated that the regulation places price, not cost, at the top of the selection criteria, thus, award is made on the basis of highest price bid.

Audit Response. We are aware that the arrangement is a sales contract and not governed by the FAR, and we did not intend for our use of the term "best value" to imply otherwise. However, the commercial venture program is not a traditional sales contract because DRMS receives a significant percentage of the net proceeds from the sale of DoD surplus property. Therefore, the costs associated with selling DoD surplus property should be a factor in awarding future contracts involving the commercial venture program.

Management Comments on Gross Rates of Return. DLA stated that the apparent drop in gross rates of return had actually begun before the commercial venture program and was attributable to the decline in the quality of property becoming available for sale. The drawdown of military services and the closing of installations in the early and mid-1990s resulted in an unusually large volume of disposed high-quality property, but that effect decreased in the later 1990s.

Audit Response. As a result of discussions with the contractor, we changed the underlying figures for gross rates of return, resulting in improved rates for the commercial venture program in comparison with previous years. We also added a section in the finding on other factors unrelated to performance that included a discussion of the declining quality of disposed property.

Management Comments on CV1 Performance. DLA stated that DRMS had no previous experience with a commercial venture partnership, and, as such, CV1 was a test of the commercial venture concept that covered only a limited number of Federal Supply Classes. Because DRMS continued to sell a large number of Federal Supply Classes, infrastructure reductions could not be realized.

Audit Response. Based on DLA comments, we removed the discussion of the CV1 performance results.

Management Comments on CV2 Performance. DLA points out that because of the alignment of interests, the contractor has an interest in reducing costs and increasing revenues. In the comments, DLA favorably compares sales revenues and net cash distributions to DRMS for FY 2002 and FY 2003 with sales revenues and after-expense net proceeds achieved by DRMS in FY 1999.

Audit Response. As a result of discussions with the contractor, we included in the final report a discussion of alignment of interests, although we believe the alignment of interests was never meant to be the sole control over contractor costs. We also revised our figures for DRMS sales revenues and acquisition value of items sold for FY 1997 and FY 1998 and for DRMS costs for all years. Because of the declining value of disposed property, we shifted the emphasis from rate of return on sales revenue to rate of return on original acquisition value. Our revised figures show for FY 2002 and FY 2003 lower rates of return than for FY 1997 and FY 1998, even allowing for doubts about the accuracy of the DRMS costs.

We did not compare FY 1999 results with the CV2 results because the Federal Supply Codes being sold were not the same. In FY 1999, the CV1 contractor sold CV1 Federal Supply Codes and DRMS sold CV2 Federal Supply Codes, whereas the CV2 contractor sells both CV1 and CV2 Federal Supply Codes.

Management Comments on Advantages of Association With the CV2 Contractor. DLA cited advantages that the contractor's parent company provides, including an Internet auction business model, active market research, technical innovation, marketing, public relations programs, and fiduciary oversight. DLA also stated that the contractor relieves the Government of legal, operational, and financial risk by assuming all risk of loss and decline in property value before resale as well as all follow-on expenses.

Audit Response. We agree that DRMS benefits from some or all of the advantages and hope that the upward trend in the first half of FY 2003 continues. However, we do not agree that the contractor assumes all risk of loss and decline in value of property, because such loss of value also affects DRMS share of sales proceeds.

Management Comments on Controls Over Costs. DLA stated that the sales contracting officer correctly allowed the merger costs because the FAR did not apply to the CV2 contract. DLA also stated that a higher level of surveillance over costs would drive up the DRMS costs and that such an action would not be necessary because of the alignment of financial interests. DLA disagrees with our conclusion that reviews have not included adequate examination of costs for reasonableness, stating that our only basis for saying so was that the commercial venture contract is not subject to the FAR. Finally, DLA commented that we did not assert any costs have actually been unreasonable.

Audit Response. We are aware that the Federal Property Management Regulation did not prohibit the allowance of the merger and acquisition costs, but our draft and final reports also make the point that costs need to be a factor in contractor selection to obtain maximum financial return to DRMS. The issue would probably not have arisen if the Federal Property Management Regulation had allowed consideration of contractor costs in award of the contract because the incumbent contractor, who would not have had any merger and acquisition costs, would probably have been selected. We agree that the alignment of financial interests should help control costs but do not believe that it can be effective as the sole cost control. Although the response to the finding objects to a higher level of surveillance over contractor costs, DLA responses to the recommendations indicate that DRMS will review the compensation levels of contractor employees and will examine merger and acquisition costs if applicable in future commercial venture arrangements. Finally, we used the FAR as a basis for comparison because the FAR has contractor cost guidelines, but we believe that control over contractor costs in the commercial venture program is desirable independent of the FAR because contractor costs directly affect DRMS share of sales proceeds.

Revised Recommendation. As a result of management comments, we revised Recommendation A.3. by removing precluding of future payment of merger and acquisition costs, recommend the careful examination of any future proposed sharing of merger and acquisition costs, and encourage consideration of having the Government receive a share of the contractor's gross proceeds in future commercial venture contracts.

Recommendations, Management Comments, and Audit Response

A. We recommend that the Commander, Defense Reutilization and Marketing Services, Defense Logistics Agency:

1. Establish adequate controls over contractor costs for the commercial venture program similar to those in the Federal Acquisition Regulation.

Management Comments. The Deputy Director, Logistics Operations, DLA partially concurred. DLA stated that DRMS is developing a review team that will audit the commercial venture contract, specifically covering Government Liquidation's purchase of supplies and services, reimbursement of employees for

expenses, and determination of levels of employee compensation including bonuses and awards. The results of the new review team will be reported to the parent company because DRMS does not have authority to change Government Liquidation's practices.

Audit Response. Although DLA partially concurred, the comments are responsive. We agree that the only practical way to establish greater controls is to increase oversight and that the current contract does not allow DRMS to change Government Liquidation practices. We commend DRMS for extending the scope of the new audits into areas beyond what we covered in our report.

2. Prepare a legislative proposal enabling the use of a best-value approach in the award of sales contracts and submit the proposal to Congress.

Management Comments. The Deputy Director, Logistics Operations, DLA concurred and stated that such a proposal had already been forwarded to DLA for submission to Congress.

3. Determine how the selection criteria for the follow-on contract will consider contractor costs, require careful examination of any future proposed Government sharing of merger and acquisition costs, and consider basing distributions to the Government on contractor gross proceeds in future commercial venture arrangements.

Management Comments. The Deputy Director, Logistics Operations, DLA partially concurred with our original recommendation. DLA stated that the current commercial venture contract grew out of a sales solicitation under the Federal Property Management Regulation, which has price as the primary contractor selection criterion. However, DLA also stated that DRMS would carefully consider the question of contractor cost when preparing the next solicitation and would examine merger and acquisition costs, to determine the degree to which the Government should share, if merger and acquisition costs become an issue in a follow-on commercial venture partnership. DLA does not agree that Government sharing of merger and acquisition costs should be precluded in all cases. Finally, DLA proposed that follow-on commercial venture arrangements might avoid the question of contractor costs entirely by specifying that the Government receive a percentage of the contractor's gross proceeds, rather than net proceeds, thereby relieving the Government of any need to monitor contractor costs and possibly strengthening the contractor's incentive to keep its costs low.

Audit Response. Although DLA partially concurred, we consider the comments responsive to the intent of the recommendation and have revised the recommendation accordingly. We still believe that the Government sharing of merger and acquisition costs represented sharing twice in the same costs and should not have happened, the situation would probably not have arisen if contractor costs had been a consideration in contract award, and DLA has agreed to consider them in the future. Other types of situations could arise where the Government's best interest would be to share in merger and acquisition costs, and DLA has agreed to evaluate such situations carefully. We agree that having the

Government receive a share of contractor gross proceeds instead of net proceeds would relieve the Government of the need to monitor contract costs and could give the contractor a stronger incentive to keep the costs low.

4. Develop new contractor performance metrics that evaluate factors such as revenue, costs, return on sales, and total income similar to other commercial businesses that would effectively judge the success or failure of the commercial venture program.

Management Comments. The Deputy Director, Logistics Operations, DLA partially concurred. DLA stated that a link exists between contract performance metrics and contract award criteria. Because the current contract was awarded primarily based on price, other award criteria were secondary at best. However, DLA is addressing the advisability of using a best-value approach in the award of sales contracts and will carefully consider this recommendation when preparing the next solicitation.

Audit Response. Although DLA partially concurred, the comments are responsive because DRMS will consider the recommendation in the next solicitation. We do not believe that a link between performance metrics and award criteria necessarily exists and point out that the first commercial venture contract considered contractor costs in the performance metrics, even though selection of that contractor was also based primarily on price. However, we also believe that under the commercial venture setup, price is a poor choice as the principal selection criterion, and DLA has concurred and is attempting to change it in response to our Recommendation A.2.

5. Determine whether the commercial venture is achieving the desired goals and results or whether the program should be terminated and other alternatives explored.

Management Comments. The Deputy Director, Logistics Operations, DLA concurred. The Defense Logistics Agency stated that our audit focuses primarily on financial results, when the commercial venture contract had achieved the intent of the political and policy decision to move non-Governmental functions into the commercial realm, cut the size and labor costs of DRMS, and make DRMS as financially self-sufficient as possible. DLA also stated that maintaining the status quo prior to the commercial venture program was not an option and that the conversion became increasingly difficult to reverse once the transition began. Therefore, DRMS is committed to the success of the commercial venture program and continues to work with and oversee the current commercial venture contractor. DLA noted that the current contractor's costs are declining and that its rates of return are increasing. Finally, DLA stated that DRMS will consider all options carefully in any follow-on arrangements.

B. Disposal of Property Items With Demand Requirements

DLA was purchasing new property items to fill requisitions while the same property items, in new or unused condition, were being disposed and sold to Government Liquidation. The condition occurred because:

- DRMS was not required to screen excess property items against DoD demand requirements and identify any open requirements such as backorders, contract orders, or purchase requests,
- DLA did not have a standard material recoupment program at all of the Defense supply centers, and
- Government Liquidation was not able to screen property items for demand and resale to DoD.

As a result, Government Liquidation received \$96 million of property items between July 2001 and July 2002 in new or unused condition that still had DoD demand requirements. DoD could have reduced costs by about \$9.2 million if property items were used to fill open requirements and could increase revenues up to \$18.7 million if property items with current demand requirements (less than 3 years of inventory) were sold back to DoD before being placed on auction.

Disposal of New or Unused Property Items

Disposal is defined as the process of reutilizing, transferring, donating, selling, destroying, or other ultimate disposition of personal property items. The process begins when a DoD activity declares material in excess of its needs and transfers the material to one of the Defense Reutilization and Marketing Offices (DRMOs). DoD Manual 4160.21-M states that DoD must reutilize excess and surplus personal property items to the maximum extent possible, filling existing needs, before initiating any new procurement or repair. All DoD activities must screen excess assets and review excess asset referrals for those assets that could satisfy valid needs. Property items are required to be screened for reutilization, donation, transfer, or exchange before being identified for sale.

Disposed Property Items With Demand Requirements. Between July 2001 and July 2002, DRMS sold 407,960 NSNs to Government Liquidation. Of that amount, 31 percent (127,961) of the NSNs were in either new or unused condition and were, by definition, serviceable and issuable without limitation or restriction. DoD Regulation 4140.1-R, "Defense Material Management Regulation," May 1998, states that material available in the material disposition system shall be used to the extent practicable to prevent concurrent procurement and disposal. However, 28 percent (35,831) of the new or unused NSNs, valued at \$96 million, had annual demand requirements as of November 2002. Table 5 shows by unit cost the number of NSNs with annual demand requirements.

**Table 5. NSNs With Annual Demand Requirements
(November 2002)**

<u>NSN Unit Cost</u>	<u>Number of NSNs</u>	<u>Number of Property Items</u>	<u>Acquisition Value</u>
Less than \$20	21,397	8,259,348	\$17,291,715
\$20.01 to \$35	2,801	182,353	6,118,020
\$35.01 to \$50	1,776	67,431	3,539,311
\$50.01 to \$100	2,890	91,386	7,594,431
\$100.01 to \$800	5,370	134,851	30,010,565
Greater than \$800	<u>1,597</u>	<u>12,924</u>	<u>31,464,615</u>
Total	35,831	8,748,293	\$96,018,657

Backorders, Open Contracts, and Purchase Requests. Some of the 35,831 disposed NSNs with demand requirements also had backorders, open contract orders, or open purchase requests that could have been partially filled with disposed quantities, thus reducing DoD costs by about \$9.2 million. We compared the 35,831 disposed NSNs to those NSNs that had backorders, open contract orders, and open purchase requests. The majority of the NSNs with backorders also had purchase requests or contract due-in quantities so we subtracted the backorders from the open contract or purchase requests. Of the 35,831 disposed NSNs, 5,417 NSNs had quantities on contract or purchase request remaining after filling the backorders. We compared the 5,417 NSNs to the disposed NSNs and identified 298,923 property items with an approximate acquisition cost of \$8.9 million that could have been used rather than disposed. We also identified 360 NSNs that had backorders that would not be filled through a purchase request or contract due-in quantity either because no purchase requests or contracts for the NSN existed or because the amount on backorder was greater than the quantity on purchase request or contract. After comparing to disposed quantities, we identified 10,943 property items with an approximate acquisition cost of \$0.3 million that could have been used to fill or partially fill the backorders.

Property Items Sold by Government Liquidation. In a judgmental sample of 44 disposed NSNs taken from the disposed NSNs with demand requirements, 24 NSNs (55 percent) were procured again within 6 months of the disposal date. Of those property items, 6 NSNs (25 percent) had a procurement action on the same date for which the property item was disposed. The disposed NSNs in the sample were coded as in new or unused condition. We attempted to track the reasons for disposal of the sample NSNs. The Defense supply centers did not, however, have records of disposal for most of the NSNs in our sample. The supply analysts speculated that most of the NSNs were probably directly disposed to the DRMO rather than following the procedure to request a credit for returning the NSN to the Defense supply center. The following are examples of disposed property items Government Liquidation sold.

-
- An Army Depot disposed of 270 property items of NSN 5320-01-033-8179, a blind rivet, with a total acquisition cost of \$10,619. Government Liquidation sold the 270 property items in a batch lot consisting of more than 2,000 property items for \$1,320; 12 percent of the original acquisition cost. On the same date that the property items were disposed, a Defense supply center procured 221 property items of this NSN for a total price of \$5,180.
 - An Air Force Supply Office disposed of 140 property items of NSN 5310-01-305-2544, a self-locking barrel nut, with a total acquisition cost of \$22,147. Government Liquidation sold the property items in a batch lot consisting of 337 property items for \$116; 0.5 percent of the original acquisition cost. Within 1 month of the disposal, a Defense supply center procured five property items of this NSN for a total price of \$1,600.
 - A Naval Supply Center disposed of 13 property items of NSN 6110-01-105-5172, a motor starter, with a total acquisition cost of \$29,019. Government Liquidation sold the property items for \$1,648; 6 percent of the original acquisition cost. Within 6 months of the disposal, a Defense supply center procured 17 property items of this NSN for a total price of \$27,924.

DLA Guidance. DLA Regulation 7000.4, “Reporting and Return of Excess Material to the DLA Distribution System,” October 1978, establishes policy and guidance for what to do with excess material and the allowance of credit for returned material. The regulation states that a total line item value of less than \$20 is the dollar threshold for returns and also disallows return of NSNs that are coded as nonstocked, precluding returns of material when the administrative, transportation, and handling costs to the Government would exceed the value of the material. DLA Regulation 7000.4 establishes a formula for the creditable level of return and a \$35 limitation for returns of non-creditable returns. Normally only new and unused material is accepted for return.

Material Returns Program. The 2002 DLA Customer Assistance Handbook provides policy for a material returns program. The program allows the return to stock of any property item that has become unneeded at the retail level. Reasons for return include programs that did not materialize, end item reductions for specific weapon systems, and requisition errors. DLA reviews the offer and determines if an unneeded retail asset can be used to fill a requirement. If the material could fill a shortfall in the approved acquisition objective (approximately 2 years of material), a credit is issued for return; if the material would fill a demand requirement for years 3, 4, or 5, the material is offered for return without credit; and if the material exceeds the 5-year demand requirement, the return is declined.

Screening Inventory for Reutilization

DRMS Instruction 4160.14, volume III, chapter 1, “Instructions for Reutilization, Transfer, and Donation for DRMS and the DRMOs,” January 2000, requires that

DRMOs reutilize, transfer, or donate excess and surplus property items for requirements. The goal of reutilization, transfer, or donation is to redistribute goods bought with taxpayer dollars to defray the cost of Federal, state, and local Governments.

Screening. DoD Manual 4160.21-M states that to satisfy needs, DoD activities must screen assets for requirements. At the DRMOs, the formal screening process requires 42 days. The first 21 days are reserved for reutilization and transfer customers and the second 21 days are open to all reutilization, transfer, and donation customers. During the screening, customers may tag the property items they want and submit requisitions for those property items. At the end of the 42-day formal screening period, DRMS allows an additional 10 days for customers to requisition and remove property items.

Reutilization. Reutilization takes place during the screening process and is accomplished visually, manually, or electronically. Customers may visit the DRMOs for viewing excess property items and tag property items they want. Once tagged, the customer may submit a requisition and remove the property items. Customers may also visit the DRMS Web site to search the property item inventory database for current inventory, view photos, identify condition and location, electronically tag property items, and electronically submit a requisition for the tagged property items. In addition, customers are encouraged to provide lists of property item requirements to the DRMOs. DRMO personnel use the lists to screen excess property items and offer those property items to the activity that lists it as a requirement. However, they are not required to screen the property items for DoD demand requirements. DRMS should require personnel to screen new or unused property items against DoD demand data and identify any property items that may have backorders, open contract orders, or open purchase requests. DRMS should then offer those property items to the requesting activity.

Standard Material Recoupment Program

Although no standard program is used by the Defense supply centers, the centers have initiatives to screen and match DRMS material for filling requirements. One program is the Automated Asset Recoupment Program, run by the General and Industrial Directorate at the Defense Supply Center Philadelphia.

Automated Asset Recoupment Program. The Automated Asset Recoupment Program is used to screen and recoup excess NSNs to fill the Defense Supply Center Philadelphia General and Industrial requirements. The original prototype was developed in June 1996, and the program was implemented in September 2000. The Automated Asset Recoupment Program screens excess NSNs on a daily basis for imminent breach of reorder point, property items on backorder, open purchase requests, and NSNs at recycling control point sites.

The program has a list of NSNs that are excluded from return to inventory. According to the analysts, the list of excluded NSNs follows the criteria of the customer returns program. However, the list also includes a list of NSNs item managers identified as not returnable for various reasons, to include safety and quality issues. In addition, the list includes property items that have been

identified as customer return improvement initiative items. Customer return improvement initiative items are selected based on poor product quality deficiency report history, critical status, or special handling requirements. The process is designed to filter customer returns at the depot level before they are placed back in the system to prevent poor quality or suspect material from infiltrating the inventory. The Automated Asset Recoupment Program also has a minimum dollar value threshold of an extended dollar value of \$25, which, according to the analyst, is based on a cost-benefit relationship. The extended dollar value is the NSN unit cost multiplied by the quantity at a DRMO.

NSN Batching. Another reason NSNs may not be recouped is because DRMO personnel can “batch,” or group together, NSNs that have an extended dollar value of less than \$800 with similar items. The objective of batching is to reduce time and costs related to physical handling and administrative processes that receiving property items individually require. When batched, however, items lose their visibility and cannot be individually screened and recouped from the DRMOs. Property specialists from DRMS stated they had planned to conduct an effectiveness test of the batching process during the summer of 2003. The specialists hoped to determine whether savings could be achieved and backorders reduced if DRMO personnel no longer batched NSNs with demand requirements.

Recoupment Savings. During the time period from October 2002 to February 2003, the Philadelphia Defense Supply Center reported that the Automated Asset Recoupment Program was used to recoup property items valued at \$405,289. Included in that figure is \$150,212 of property items that were on backorder. Those NSNs were provided to the DoD component at no cost. The analysts stated that they are in the process of exporting the program to two other supply centers, but the program needs to be adjusted for each center’s individual product lines. DLA needs to implement a standard material recoupment program, such as the Automated Asset Recoupment Program, at all the Defense supply centers.

Contractor Screening for Reutilization

Government Liquidation was not able to screen property items for demand and resale to DoD. One of the reasons the supply analysts provided for disposal of the property items with demand requirements was timing differences as a result of the dynamic demand cycle. Because of the dynamic demand cycle and the possibility of changing requirements, it would make sense for Government Liquidation to screen its inventory for property items that were disposed with less than 3 years remaining inventory for resale to DoD before placing the property items on auction.

Current Demand Requirements. The demand cycle of an NSN is dynamic, and requirements can easily change from one quarter to the next. To determine the amount of time before the inventory of an NSN is depleted, we developed a “years until buy” formula. The years until buy formula is the sum of the inventory on hand plus contract due-in quantity less the quantity on backorder divided by the annual demand quantity of an NSN. For example, if the annual demand quantity for an NSN is 10 property items per year and 100 property items

are in stock, the years until buy for the NSN is 10 years. However, if the annual demand quantity were to increase from 10 property items to 50 property items per year, and 100 property items are still in stock, the years until buy decreases to 2 years. We calculated the years until buy for the 35,831 NSNs, valued at \$96 million, based on annual demand quantities and inventory levels. Figure 5 shows the acquisition value of NSNs with 3 years or less of inventory, or current demand requirements, is \$46.8 million.

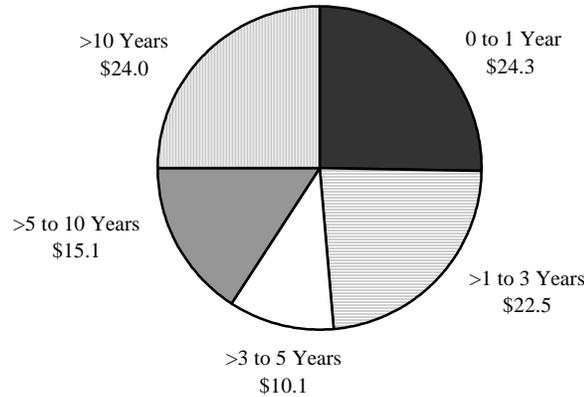


Figure 5. Years Until Buy For Disposed NSNs With Demand (in millions)

Economic Retention Level Policy. Supply analysts stated that NSNs may be disposed, even though demand for the property items still exists, because more inventory is on hand than needed for future requirements. DLA policy is to base disposals on inventory levels at a specific point in time using an economic retention level formula, but because the demand cycle is dynamic, inventory requirements can change from one quarter to the next. For example, NSN 6105-01-241-2451, a shaft and wheel motor, had 143 property items in inventory and the quarterly forecasted demand was 3 items. In April 2001, 71 property items were disposed, leaving 72 in inventory. The Supply Branch Chief at the activity concluded that the property items were disposed because the NSN was on an excess disposal project and had erratic demand. However, less than a year later, in February 2002, only 14 property items remained in stock and a purchase request for 41 property items of the NSN existed. If Government Liquidation could have screened the property items for demand, they may have held a portion of the 71 disposed property items and offered them for resale to DoD, thereby filling the purchase request for 41 property items.

Reasons for Property Item Disposal. According to the supply analysts and property specialists interviewed, no quick answers exist as to why NSNs are disposed while a need for those NSNs still exists. Reasons that some of the disposed NSNs would not be available or could not be reused included incorrect codes, unidentified sources of supply, deficiency reports, quality or safety issues, or shelf life concerns. A supply analyst also stated that if NSNs were coded as nonstocked NSNs or coded for direct vendor delivery, the supply center would not accept the return of the NSN because no storage location for the NSN existed. The analyst indicated the Services dispose of NSNs for other reasons that include

minimum value for credit returns, response delays, credit returns denied as a result of the prohibitive costs of testing suspect material, and material not accepted by the supply centers for monetary credit.

We recognize valid reasons may exist that some of the disposed NSNs would not be available or could not be reused. However, if 50 percent of the NSNs could be sold back to DoD for filling current requirements (less than 3 years inventory), the return could be up to \$18.7 million (50 percent of \$46.8 million, multiplied by the 80 percent that DRMS receives under the CV2 contract). DRMS should have procedures in place for attempting reutilization of inventory with quantities on backorder, purchase request, or open contract. Although various chances to screen DRMO property items for filling customer requirements exist, many property items do not get looked at and fall through the screening programs. If it could screen items for demand, Government Liquidation would give DoD a final chance to recoup property items before they are sold to the public. DRMS should also negotiate with Surplus Acquisition Venture and modify the contract so that it will allow Government Liquidation to screen property items for demand and resale to DoD to help counter the effect of timing differences and erratic requirements. Although that arrangement will still cost DoD a percentage of the acquisition cost, based on the CV2 contract terms, 80 percent of the sale proceeds would be returned to DoD. That 80 percent is significantly higher than 80 percent of the amount received through surplus sales.

Conclusion

Of the NSNs in new or unused condition disposed and sold from July 2001 to July 2002 to Government Liquidation, 28 percent had demand requirements. Our analysis shows that DoD could have saved money by filling backorders, purchase requests, and open contracts rather than disposing of property items and reacquiring those items at a higher acquisition cost. We realize that the demand cycle is dynamic and requirements for property items could potentially change, and that not all disposed property items have potential for reutilization; however, if disposed items were used to fill backorders, purchase requests, and open contracts, up to \$9.2 million would have been saved. Additionally, if 50 percent of the disposed property items with less than 3 years until buy were sold back to DoD by the contractor, DRMS revenues could increase by up to \$18.7 million.

DoD could have reutilized some property items to fill requisitions and satisfy requirements instead of selling the property items in the private sector for a small percentage of the acquisition cost. We recognize that recouping DRMO assets is a competitive process with a minimal time frame of asset availability. Funds can be saved, however, if the Defense supply centers continue to search the DRMS assets for available property items that could satisfy needs; DRMS screens new and unused property items for backorders, open contract orders, open purchase requests; and Government Liquidation screens the property items they purchase for demand requirements and resale to DoD.

Recommendations, Management Comments, and Audit Response

B.1. We recommend the Director, Defense Logistics Agency issue guidance that implements a standard material recoupment program, such as the Automated Asset Recoupment Program, at the Defense supply centers.

Management Comments. The Deputy Director, Logistics Operations, DLA concurred stating that a standard automated recoupment program is being designed for the DLA Business Systems Modernization effort. The recoupment function is expected to be available in calendar year 2005.

B.2. We recommend the Commander, Defense Reutilization and Marketing Service, Defense Logistics Agency:

a. Issue guidance for screening new or unused property items with demand requirements against backorders, open contract orders, and open purchase requests and notify customers property when items are available.

Management Comments. The Deputy Director, Logistics Operations, DLA partially concurred. DLA stated that guidance for screening items for re-issue within DoD is already well established and the requisitioner is responsible for screening for available assets and recouping them, where appropriate. DLA suggested that the audit recommend process improvements that would make available DRMS assets more visible for screening. For example, DRMS is testing the matching of DLA Inventory Control Point Want Lists for new or unused items \$800 and less against Generator Pre-Receipt/Due-In notices to support the Inventory Control Point backlog reduction. The target date for the completion of the test results is February 2004.

Audit Response. We consider the comments partially responsive. We acknowledged the DLA batching initiative in the Screening of Inventory for Reutilization section of the report and agree that the initiative should assist with making available DRMS assets more visible for screening. However, 33 percent of the \$96 million of new or unused property items with demand requirements received by Government Liquidation had a unit price of \$800 or greater. Therefore, we request that the Deputy Director, Logistics Operations, DLA provide additional comments in response to the final report.

b. Instruct that the sales contracting officer negotiate with the contractor modification of contract 99-0001-0002 to include screening new or unused property items for demand and resale to DoD.

Management Comments. The Deputy Director, Logistics Operations, DLA did not concur. DLA stated that the Government Liquidation contract already has provisions for DRMS to withdraw items from Government Liquidation sales if a valid Government requirement is documented. For DRMS to dictate a contract modification for the purpose the IG proposes would distort the incentives that the commercial venture contract is built on, compelling Government Liquidation to sell noncompetitively to DoD entities items that they have up until now sold

competitively on the open market. The commercial venture was designed as a risk and reward sharing, public-private partnership that would free the commercial venture purchaser from the policy constraints that DRMS sales operations were forced to operate under and would encourage best business practices. Moreover, DoD supply activities can search the Government Liquidation Web site for items on sale that could be used to fill backorders or offset new procurement, and bid for these items along with other participants.

Audit Response. DLA comments are nonresponsive. Historically, Government Liquidation has received only about 2 percent return on acquisition value for the property items sold through Internet auctions. The intent of our recommendation was for Government Liquidation to sell property items in demand by DoD at the full acquisition value or at a percentage of the acquisition value higher than the value that would be received through an Internet sale to a public bidder, therefore increasing the return for both Government Liquidation and DRMS. Therefore, we ask that the Deputy Director, Logistics Operations, DLA reconsider her position and provide additional comments to the final report.

C. Processing of End-Use Certificates

The Defense Logistics Agency Criminal Investigations Activity (DCIA) did not process 130 end-use certificates from Government Liquidation customers that were more than 90 days old, and Government Liquidation stated that sales of applicable items were impaired and that they incurred additional costs for storing and handling the unsold items. End-use certificates are statements of a purchaser's intended use of certain controlled items. The backlog exists because before award of the CV2 contract, DCIA concluded that previous processing was not stringent enough and cancelled the existing clearances, which resulted in a substantial workload. As a result, DRMS revenue decreased by an unknown amount, including approximately \$1.07 million for which the contractor reduced distributions to DRMS because of the perceived extra costs.

Small Business Association Complaint

We originally looked at this issue because of a complaint from a small business association about the certificate requirement. The small business association later told us that they were satisfied on the original complaint but were concerned about delays in the processing of the certificates. We substantiated the complaint about the delays as detailed in this finding. See Appendix B, Issue 4, for details about the complaints.

End-Use Certificate Requirement

DLA Requirement. DLA is required to collect and verify end-use certificates from purchasers of certain excess personal property. DoD Directive 2030.8, "Trade Security Controls on DoD Excess and Surplus Personal Property," November 17, 1997, states that DoD must ensure that DoD surplus property designated as munitions list items (MLI) or commercial control list items (CCLI) are transferred in accordance with U.S. laws, regulations, and policies. The policy requires end-use certificates from purchasers of such property. The directive defines the end-use certificate as, "A statement by a prospective purchaser or other transferee indicating the intended destination and disposition of MLI and CCLI property to be purchased/transferred, and acknowledging U.S. export license requirements."

The directive designates the Director, DLA as the program monitor for policy implementation of trade security control policy and procedures for transfers of DoD excess and surplus personal property by the DoD. DLA has implemented the DoD Directive in DLA Instruction 2030.1, "Trade Security Control Procedures Applicable to Department of Defense Surplus Property and Foreign Excess Personal Property," October 17, 2001.

CV2 Requirement. One difference between CV1 and CV2 is that Government Liquidation handles MLI and CCLI property. The CV2 contract requires, therefore, that the contractor ensure buyers of MLI and CCLI property have

proper clearances. Specifically, the CV2 contract requires that the contractor obtain an “End-Use Form 1822” from prospective buyers of MLI and CCLI property, submit the form to DRMS, and confirm with DRMS that the buyer is cleared for the purchase before releasing the property.

DLA Processing of End-Use Certificates

According to DoD Directive 2030.8, the DLA implementation duties include “Verifying the stated [in the certificate] end use, end user, and destination of the MLI or CCLI.” DCIA actually performs the verification. DCIA personnel told us that the Battle Creek, Michigan Trade Security Controls Clearance Office of the DCIA now performs all of the processing. Previously, that office performed the initial processing of the certificates and sent the certificates to the Memphis, Tennessee Trade Security Controls Clearance Office for the main processing. At the end of the process, DCIA determines whether the customer is cleared and whether the sale can proceed. Although prospective Government Liquidation customers must file a new certificate for each sale of applicable items, a customer’s clearance is good for 5 years once granted, and certificates filed during those years do not require extensive processing.

Processing Time of End-Use Certificates. DCIA officials recognize that the processing time of certificates has been excessive. According to DRMS personnel, DLA had 387 certificates as of March 27, 2003, from Government Liquidation customers awaiting processing. Of those 387 certificates, 130 were pending for more than 90 days.

Causes and Proposed Corrections. Shortly before award of the CV2 contract, DCIA cancelled all the previous trade security clearances. DLA officials told us that the cancellation occurred because they had determined that the existing clearance process was not sufficiently stringent. The DLA officials also stated that the cancellation was unrelated to the upcoming CV2 award. Subsequently, the events of September 11, 2001, caused a new emphasis on strict compliance with security measures. Additionally, DCIA personnel stated that slow responses to necessary inquiries, beyond DCIA control, caused some of the delays.

DCIA has considered the matter enough of a priority to reassign a person full time to finding solutions. As a major part of the effort for improving certificate-processing time, DCIA personnel stated that they closed the Memphis operation and consolidated processing in Battle Creek as of April 5, 2003. We consider that a good step. DCIA has already accomplished some additional improvements, such as working with the contractor to prioritize certificates related to larger sales, and DRMS records show that the number of pending certificates more than 90 days old has decreased from 289 certificates as of January 13, 2003, to 130 certificates as of March 27, 2003.

Effect on DRMS Revenue

Sale of Items Requiring Certificates. Although the CV2 contract was awarded June 13, 2001, the contractor did not sell until October 2001 any items requiring

certificates. Sales for October 2001 were only \$*¹¹. Sales of items requiring certificates have increased greatly to about \$*¹¹ for the first 6 months of FY 2003. However, as of March 2003, the contractor continued to perceive an impairment of ability to sell the applicable items. The contractor has expressed ongoing dissatisfaction with the certificate process through actions as explained in the following sections.

Withholding Initial Payments.

*¹²

Contractor Claim for Lower Sales Returns on Items Sold.

*¹²

Contractor Costs Arising from Certificate Processing Delays.

*¹²

Conclusion

DCIA has taken positive steps to improve the time required to process end-use certificates. The consolidation of processing to one location should lead to further improvement. Nevertheless, the contractor perceives a continual impairment of sales as a result of certificates that are not processed in a timely manner. Although the contractor stopped withholding initial payments for unsold items and dropped the claim for lower proceeds on sold items, any adverse effect on the timing or amount of contractor sale proceeds that were the basis for the actions also represent an unknown adverse financial effect on DRMS. The contractor also believes that the unsold items have increased contractor costs, and as a result, continues to charge costs as seller indirect costs, reducing DRMS proceeds by \$*¹¹ from November 2001 through March 2003. Keeping security concerns in mind as appropriate, DLA should resolve the issue of backlogged end-use certificates.

Recommendation and Management Comments

C. We recommend that the Director, Defense Logistics Agency Criminal Investigations Activity, accelerate elimination of the backlog for unprocessed end-use certificates as well as prevent any future backlogs.

Management Comments. The Deputy Director, Logistics Operations, DLA concurred. DLA reported that as of September 26, 2003, the DCIA had only 68 end-use certificates pending, of which 5 were more than 90 days old.

¹¹ This figure represents contractor proprietary data that has been deleted.

¹² This area of the report represents contractor proprietary data that has been deleted.

D. Controls Over Noncompetitive and Reduced-Competition Sales

Although the contractor reduced the amount of noncompetitive and reduced-competition sales to about \$0.2 million for the first half of FY 2003, sales below market value may occur. Sales below market value may occur because the contract and the Federal Property Management Regulation do not provide applicable coverage and because DoD reviews of noncompetitive and reduced-competition sales were minimal. As a result, DRMS may receive less revenue if noncompetitive and reduced-competition sales result in sales below the market value.

Noncompetitive and Reduced-Competition Sales

Government Liquidation categorizes its sales as Internet sales, sealed bid sales, and “private treaty sales.” No clear definition of private treaty sales was in contractor literature, and contractor personnel were unable to explain the term. The private treaty sales include both sales to one bidder with no attempted competition and sales with limited competition. For the purposes of this report, we will refer to private treaty sales as noncompetitive and reduced-competition sales.

*¹³

Small Business Association Complaint

We originally looked at this issue because of a complaint from a small business association. We substantiated the allegation that in CV1 and CV2 noncompetitive and reduced-competition sales, no assurance existed that property would be sold using full-and-open competition. However, noncompetitive and reduced-competition sales have dropped substantially under CV2. See Appendix B, Issue 1, for details about the complaint.

Contract Requirements on Noncompetitive and Reduced-Competition Sales

The contract does not mention noncompetitive and reduced-competition sales and does not contain either a requirement or a preference for competitive bidding in the resale process. The section on contractually allowed compliance reviews contains nothing specific on how to review sales of the commercial venture contractor.

¹³ This area of the report represents contractor proprietary data that has been deleted.

Federal Property Management Regulation. The applicable portion of the Federal Property Management Regulation, 41 Code of Federal Regulations (C.F.R.) 101-45, “Sale, Abandonment, or Destruction of Personal Property,” July 1, 1999, does not cover the contractor’s noncompetitive and reduced-competition sales. Instead, the C.F.R. covers sales of property the Government owns, not sales when the contractor owns the property. However, because the Government has an interest in the commercial venture contractor’s sales proceeds, we believe some similar controls would be appropriate.

The C.F.R. favors competitive bidding for Government sales of property. Section 304-2 generally permits noncompetitive negotiated sales to private concerns when public exigency exists, when the estimated fair market value does not exceed \$15,000, or when an earlier attempt to advertise for bids was not successful. Unless the law specifically authorizes the sale and before any negotiated sale, the head of the selling agency, designee, or the Administrator of General Services must approve a written justification.

In the interest of having similar controls, we believe that some written justification, with documented approval by someone other than the person deciding to conduct a noncompetitive or reduced-competition sale, would help avoid the use of such sales when full-price competition would be worthwhile. We further believe that the method used for arriving at a fair and reasonable price should be documented.

DoD Oversight Of Noncompetitive and Reduced-Competition Sales. DRMS could improve controls over noncompetitive and reduced-competition sales in several respects. DRMS oversight of the sales was minimal, and the Defense Contract Audit Agency, under procedures agreed upon with DRMS, does not address such sales.

DRMS Reviews. DRMS oversight over noncompetitive and reduced-competition sales was minimal. DRMS reviews have covered those types of sales, but the reviews never tested the justification for having a noncompetitive or reduced-competition sale or the way fair and reasonable prices were determined. One review identified a potential internal control weakness in the area of noncompetitive or reduced-competition sales that the CV1 contractor conducted. In the review for the period January 1 through June 30, 2000, DRMS found that because of required manual intervention and a lack of internal controls applicable to other types of sales, Levy/Latham Global could misplace bids and award reduced-competition sales to someone other than the highest bidder. The report said that the problem needed to be addressed, but there were no subsequent DRMS reviews under CV1 to indicate whether DRMS addressed it.

Defense Contract Audit Agency Reviews. As discussed in finding A, the Defense Contract Audit Agency periodically reviews compliance with the contract as well as applicable laws and regulations. The Defense Contract Audit Agency reviews are limited to procedures agreed upon with the sales contracting officer. The procedures cover other types of sales, but not noncompetitive or reduced-competition sales. DRMS should include the noncompetitive and reduced-competition sales as a category in the Defense Contract Audit Agency reviews of the commercial venture program.

Contractor Internal Procedures. Government Liquidation has detailed procedures on recording noncompetitive or reduced-competition sales, but the procedures contain little guidance on the circumstances that justify a noncompetitive or reduced-competition sale, the method of arriving at a fair and reasonable price in the absence of competition, or any higher-level approval required. The guidance states that site managers should work with customers to arrive at a price and should process only noncompetitive or reduced-competition sales that meet certain rate-of-return requirements. Regional managers approve only noncompetitive or reduced-competition sales that do not meet rate-of-return requirements or that exceed \$2,000 in the sales price for one or more single Disposal Turn-In Documents.

Sample Results. We selected a judgmental sample of 28 noncompetitive or reduced-competition sales executed in October 2001. Government Liquidation headquarters collected responses from the various sites and submitted them to us. The responses for approximately half of the items, 15 of the 28, indicated no price competition at all, while the remaining 13 indicated some competition.

Although we did not find evidence of any clearly improper sales, we did find two sales that did not comply with Government Liquidation's official procedures. The two sales both contained Disposal Turn-In Documents that sold for more than \$2,000, but the Government Liquidation response to us did not indicate regional manager approval, as required. We also did not find documentation of higher-level approval, the reasons for conducting a noncompetitive or reduced-competition sale, or the method of arriving at a fair and reasonable price.

Conclusion

Although we acknowledge that in some cases the cost of conducting full-competition sales might outweigh the benefits, DRMS could be losing revenue in the noncompetitive or reduced-competition sales if items are sold for less than could have been obtained with full competition. The absence of a requirement for documented approval of such sales makes inappropriate use of the type of sales by one person possible. The absence of documentation of the reasons for not using full competition and of the methods for arriving at a fair and reasonable price make answering any follow-on questions about whether the sale was appropriate difficult.

Government Liquidation shows a preference for fully competitive sales. As noted, reported noncompetitive and reduced-competition sales were about \$1.4 million during FY 2002 but only about \$0.2 million for the entire first half of FY 2003. We commend Government Liquidation for the reduction in the use of noncompetitive and reduced-competition sales but believe additional control over the remaining sales is necessary. The controls should include coverage of noncompetitive and reduced-competition sales in Defense Contract Audit Agency reviews.

Recommendation, Management Comments, and Audit Response

D. We recommend that the Commander, Defense Reutilization and Marketing Services, Defense Logistics Agency:

- 1. Monitor the dollar level of reported noncompetitive and reduced-competition sales for any significant increase.**
- 2. Include the noncompetitive and reduced-competition sales as a category in Defense Reutilization and Marketing Services and Defense Contract Audit Agency reviews of the commercial venture program.**

Management Comments. The Deputy Director, Logistics Operations, DLA concurred with Recommendations D.1. and D.2. and stated that the DRMS review team would audit the sales.

3. In solicitations for any future commercial venture contracts, express a preference for fully competitive sales and specify some minimum documentation and approval requirements for any contractor sales where competition is restricted.

Management Comments. The Deputy Director, Logistics Operations, DLA did not concur. DLA stated that even when DRMS conducted its own sales, the sales were not fully competitive when necessary and that part of the reason for moving the sales into the private sector was to take advantage of the contractor's ability to apply best business practices. DRMS does not believe that the contractor should be prohibited from conducting those types of sales "unless it can be demonstrated that he is consciously acting against the best interest of the Government."

Audit Response. DLA comments are not responsive. Our recommendation was not intended to prohibit noncompetitive and reduced-competition sales in future commercial venture contracts but to make the preference for fully competitive sales clear to the contractor. We believe that documentation and approval requirements need to exist so that the Government will be able to evaluate the appropriateness of the sales and determine whether the contractor is acting in the best interest of the Government. We request that DLA reconsider its position on the recommendation and provide additional comments in response to the final report.

E. Payments on Financial Advisor Contract

Government Liquidation may continue to pay the financial advisor 2.25 percent of the DRMS share of revenue for the entire 7 years of the CV2 contract, rather than the 5 years the financial advisor contract requires. The condition exists because the CV2 contract does not require Government Liquidation to stop the financial advisor payments. As a result, the financial advisor may receive payments longer than what was agreed, with a possible cost to DRMS of about \$1.13 million.

Financial Advisor Contract

DRMS awarded financial advisor contract SP4410-97-C-1000 to Kormendi-Gardner Partners on December 18, 1996. The contractor provided financial advisory services to DRMS for assets that would be included in one or more DRMS commercial venture transactions. Services included providing immediate capability and experience to assist DRMS in structuring the commercial venture transactions.

The ongoing payments to the financial advisor are compensation for the financial advisory services described above. The financial advisor contract requires payment to the financial advisor of 2.25 percent of the net proceeds DRMS receives from the commercial venture. The payments include 2.25 percent of initial payments for inventory and 1.8 percent of net distributions of sales proceeds (2.25 percent of the DRMS 80 percent). The proposed commercial venture organization, not DRMS, must make the payments. The financial advisor provided services related to the commercial venture program for both the CV1 contract and the CV2 contract.

Duration of Payments per Contracts

Financial Advisor Contract. The financial advisor contract states, “Contractor eligibility for compensation . . . shall run continuously for a period of 5 years commencing on the date of [commercial] venture formation.” DRMS awarded the CV1 contract on July 14, 1998, and the CV2 contract on June 13, 2001. Based on the CV2 award date, the date for cessation of financial advisor payments is June 13, 2006.

CV2 Contract. The CV2 contract is for 7 years. The sections of the CV2 contract that cover payments to the financial advisor do not contain any information about stopping the payments at any time, implying that they should continue for the entire 7 years, or until June 13, 2008.

Results of Discussions With DRMS Personnel. DRMS personnel agreed that a problem existed, and they have been working to correct it. DRMS personnel stated that they have notified the financial advisor that compensation for property awarded under CV2 will continue through June 12, 2006.

Effect of Ambiguity of Duration of Payments

If DRMS does not address the ambiguity, payments to the financial advisor are likely to continue for the 7-year duration of CV2 even though the payments should have been limited to 5 years. The additional payments would come out of money that DRMS would otherwise receive in initial payments for inventory and monthly distributions of sales proceeds. The amount of money depends on future events and cannot be determined at this time. For a rough estimate, Table 6 shows that the FY 2002 payments to Kormendi-Gardner Partners, for initial inventory payments and sales proceeds distributions, were \$565,425. Approximately 2 extra years of payments at that level would be about \$1.13 million.

Table 6. Payments to Financial Advisor for CV1 and CV2

	<u>FY 97</u>	<u>FY 98</u>	<u>FY 99</u>	<u>FY 00</u>	<u>FY 01</u>	<u>FY 02</u>
Initial Payments	\$* ¹⁴					
Commission Payments	<u>*¹⁴</u>	<u>*¹⁴</u>	<u>*¹⁴</u>	<u>*¹⁴</u>	<u>*¹⁴</u>	<u>*¹⁴</u>
Total Annual Payments	\$*¹⁴	\$*¹⁴	\$*¹⁴	\$*¹⁴	\$*¹⁴	\$*¹⁴

Recommendation and Management Comments

E. We recommend the Commander, Defense Reutilization and Marketing Services, Defense Logistics Agency direct that Government Liquidation stop making payments to the financial advisor, effective June 13, 2006.

Management Comments. The Deputy Director, Logistics Operations, DLA concurred stating that the financial advisor had been notified that compensation for property awarded under the first commercial venture contract, awarded July 14, 1998, ceased on July 13, 2003, and that compensation for property awarded under the second commercial venture contract, awarded June 13, 2001, would cease June 12, 2006. However, the financial advisor had hired legal counsel, and DRMS was reviewing the legal issues the financial advisor raised.

¹⁴ This figure represents contractor proprietary data that has been deleted.

Appendix A. Scope and Methodology

Scope and Methodology

We interviewed officials from DLA, DRMS, and Government Liquidation to obtain background information, NSN data, and end-use certificate processing information, as well as revenue and cost figures. We reviewed the Federal and DoD regulations to identify criteria that pertain to sales contracts and property disposal. We identified background information on DLA, DRMS, and the commercial venture program. We reviewed both the CV1 and CV2 contracts to determine contract specifications and costs. The documents we reviewed were dated February 1996 through April 2003. We reviewed the financial advisor contract; Government Liquidation payroll documents; Government Liquidation lease agreements; Government Liquidation initial payments for property; Government Liquidation Monthly Reports to DRMS; Government Liquidation quarterly reports to DRMS; and other documentation on Government Liquidation expenditures. We reviewed Government Liquidation sales and inventory procedures and examined a sample of noncompetitive and reduced-competition sales.

We performed this audit from November 2001 through August 2003 in accordance with generally accepted government auditing standards.

We selected judgmental samples of contractor cost categories, property items disposed by DoD, and noncompetitive and reduced-competition sales.

For contractor costs, we judgmentally chose August, September, and October of 2001 during a visit to Government Liquidation. We examined trial balances of expense accounts and selected accounts with the heaviest activity for those months. For the selected accounts, we examined support for the expenses. For October, we examined the actual cash flow, on which the contractor-reported costs are based, in relation to the amounts posted to expense accounts and did not find any marked discrepancies.

For property items that DoD disposed, we obtained from DRMS delivery orders of the NSNs sold to Government Liquidation. We compiled the delivery orders, derived a list of NSNs with condition codes indicating new or unused condition, and requested from DLA a database of demand requirements, backorders, purchase requests, and contract orders for the NSNs. We isolated the NSNs with demand dollars that exceeded \$25,000 and judgmentally selected 44 sample items for further examination. The criteria for selection were high acquisition value, high surplus amounts, surplus amounts greater than or equal to amounts in an open purchase request, constant demand, or low inventory.

We selected the sample of 28 noncompetitive and reduced-competition sales from a Government Liquidation report of private treaty sales for October 2001. The judgmental selection was based on extremely high acquisition value, extremely

high or low resale price, extremely high or low sale price in relation to acquisition value or cost to Government Liquidation from DRMS, or other unusual appearance of the sale.

Use of Computer-Processed Data. We relied on computer-processed data from DLA (Standard Automated Material Management System), DRMS (DRMS Automated Information System), and Government Liquidation (One World System) provided for identifying NSNs that were turned over to the contractor for disposal, resale customers for the disposed material, NSNs DoD recently purchased, and the procuring activity for any recent NSN purchases. We also relied on Government Liquidation and Levy/Latham Global financial results, as reported to DRMS, for contractor results figures and on DRMS financial systems for DRMS results before the commercial venture program and continuing related DRMS costs since the beginning of the commercial venture program. We compared contractor records of payments to DRMS with DRMS receipt records. We did not perform a formal reliability assessment of the computer-processed data. However, to the extent that we reviewed the data, we did not find any errors that would preclude use of the data to meet the audit objective or that would change the conclusions in this report. Additionally, we believe we can rely on the contractor financial data to some extent because both the CV1 and the CV2 contracts require an annual financial audit, and the applicable contractor has received an unqualified opinion for FY 1998 through FY 2002. Based on our own audits of DoD financial statements, we have limited confidence in the DRMS financial figures but do not believe any differences would change our overall assessment of the results from the commercial venture program.

General Accounting Office High-Risk Areas. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the DoD Inventory Management and Contract Management high-risk areas.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of DRMS management controls over contractor costs. Specifically, we reviewed the adequacy of DRMS management controls over costs the contractor reported. We also reviewed the adequacy of management's self-evaluation of this control.

Adequacy of Management Controls. We identified material management control weaknesses for DRMS as defined by DoD Instruction 5010.40. DRMS management controls for contractor costs did not ensure that costs were not excessive. Recommendations A.1., A.2., A.3., A.4., and A.5., if implemented, will either correct the identified cost control weaknesses by ensuring an acceptable return to DRMS or will lead to the termination of the commercial

venture program. Implementation of the recommendations could result in monetary benefits, but the amounts are indeterminable because they depend on unknown future levels of surplus material that will become available for resale. A copy of the report will be provided to the senior official responsible for management controls in the DRMS.

Adequacy of Management's Self-Evaluation. DLA officials did not identify anything below the level of DRMS as a whole, such as the commercial venture program, as an assessable unit, and, therefore, did not identify or report the material management control weaknesses identified by the audit.

Prior Coverage

During the last 5 years, the Inspector General of the Department of the Defense (IG DoD) has issued three reports discussing DRMS and the commercial venture program. Unrestricted IG DoD reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

IG DoD

IG DoD Report No. D-2003-101, "Law Enforcement Support Office Excess Property Program," June 13, 2003

IG DoD Report No. D-2002-043, "Defense Reutilization and Marketing Service Public/Private Competition," January 25, 2002

IG DoD Report No. D-2002-025, "Allegations Concerning Defense Reutilization and Marketing Service Business Practices," December 17, 2001

Appendix B. Responses to Issues Raised by a Small Business Trade Organization

The second objective of the audit was to evaluate whether the privatization of the program has adversely affected small businesses that purchase, sell, and operate military surplus aircraft parts. The following issues were brought to our attention by a small business trade organization, the National Association of Aircraft and Communication Suppliers, Incorporated (NAACS). NAACS is an organization of approximately 120 small businesses that represent a broad spectrum of the aviation community. NAACS members routinely purchase from DRMS assorted spare aircraft parts, place them in their inventories, and look for resale opportunities. While all of the allegations NAACS made were true to varying degrees, only two (Issue 1, Noncompetitive and Reduced-Competition Sales, and Issue 2, Missing and Incorrect Condition Codes and National Stock Numbers) had an adverse effect on small business attributable to privatization of the program. Issue 4, End-Use Certificates, had an adverse effect on small business but had nothing to do with the privatization of the program (finding C). Issue 1 is covered in more detail in finding D. The contractor is working to correct the other issue as noted under Issue 2 below.

Issue 1. Noncompetitive and Reduced-Competition Sales

The complainant alleged that in the CV1 and CV2 noncompetitive and reduced-competition sales, there are “no assurances that property will be sold using full and open competition.” The complainant stated that at one time, Government Liquidation intended to discontinue private treaty sales, but the complainant was concerned that Government Liquidation might change its mind.

Audit Results. The issue was substantiated, and the problem was attributable to privatization of the program. Government Liquidation has continued to conduct noncompetitive and reduced-competition sales, although to a lesser extent than the CV1 contractor. As shown in finding D, the level of noncompetitive and reduced-competition sales decreased greatly during the first half of FY 2003, but DRMS still needs to institute additional controls. The recommendations in finding D should correct the problems. Government regulations would prevent those types of problems if the Government were still conducting the sales. For noncompetitive and reduced-competition sales that have no price competition, Government Liquidation does not always have documented justification and approval for the lack of competition or documentation of the method of arriving at a fair and reasonable price. When price competitions exist in noncompetitive and reduced-competition sales, the sales may not be as widely advertised to prospective bidders as sealed bid and Internet sales.

Issue 2. Missing and Incorrect Condition Codes and National Stock Numbers

The complainant alleged that Government Liquidation is not always supplying condition codes or NSNs on property put up for bids and that the information is

often incorrect when supplied. Without accurate information, the complainant alleged that bidders are forced to blindly submit their bids.

Audit Results. The issue was substantiated as to both missing and incorrect information, but only the missing NSNs and condition codes could be attributed to privatization of the program. Government Liquidation information on property for sale contains incorrect NSNs, but the incorrect NSNs cannot clearly be attributed to the commercial venture program in general or to Government Liquidation in particular. Both the DRMS Sales contracting Officer and the DRMS Small Business Representative believe that any bad data originated in DRMS. We obtained copies of the same data that DRMS has provided to commercial venture contractors on items turned over for sale in the commercial venture program. Obviously incorrect NSNs, containing alphabetic characters, are very easy to spot in the data. We, therefore, find the DRMS position, that data was also inaccurate before the commercial venture program, probable.

Although it did not affect a majority of the property as alleged, the absence of condition codes and NSNs for items on the Government Liquidation Web site was substantiated, was attributable to Government Liquidation, and could have an adverse effect on small business. We discovered examples where property listed for Internet auction had missing NSNs, condition codes, or both. Specifically, the boxes where this information should have appeared were completely blacked out. Only one instance of a blank NSN or condition code existed in the data that DRMS gives to the commercial venture contractor. Therefore, Government Liquidation would be responsible for the blacked-out NSNs and condition codes. Government Liquidation acknowledged the problem and is addressing the issue through additional training and modification to internal procedures. The sales contracting officer agreed to monitor the corrective action. The problem was not yet completely resolved as of September 2003.

Issue 3. Disclosure of Winners

The complainant alleged that, "Government Liquidation does not publish the name of the successful bidder," in contrast to when the sales were conducted by DRMS, and the winning bidder's identity was routinely available to the public. The NAACS members want this information publicly released because they want to know that the company who outbid them is a legitimate business and that the sales are being conducted legitimately. NAACS members feel that disclosing the names of winners should promote the exchange of information and sales within the industry as well as help to substantiate the legitimacy of the commercial venture program in general.

Audit Results. The issue was substantiated; however, no clear adverse effect on small businesses is apparent. Government Liquidation does not publish the winning bidder's name because of concern for the confidentiality of the winning bidder's identity. Although the NAACS took a poll of its members and the majority did not object to having their names released as the winning bidder, other small businesses may still object. Furthermore, the sales contracting officer believed that publishing bidder names would involve a change order to the contract, and therefore a cost to the Government, to require the contractor to disclose the winning bidder's name. Because some businesses might object to the

disclosure, we do not believe pursuing such a change to the contract is in the interest of the Government. The sales contracting officer also pointed out that upon request, Government Liquidation would provide names to the winning bidder of companies that wanted to be contacted in regard to the material just purchased.

Issue 4. End-Use Certificates

The complainant originally alleged that, “The DLA implementation of and continued use of End-Use Form 1822, through Government Liquidation, presents an enormous, insurmountable obstacle for [small businesses] to compete for surplus sales conducted by Government Liquidation.” NAACS felt that the End-Use Form 1822 imposed obligations on businesses that were illegal, unnecessary, and burdensome, and that the form was lacking in clarity and inaccurate with respect to the application of export laws. During the course of the audit, NAACS representatives told us that they had obtained satisfaction on the original complaint through other channels. However, by that time the NAACS representatives had become concerned with the length of time it was taking DLA to process end-use certificates.

Audit Results. During the audit, the NAACS worked with the Office of Management and Budget to make changes to the end-use certificate. The NAACS representatives stated that the results of the meetings were satisfactory. We, therefore, did not continue pursuing the original allegations.

The allegation of delay in processing the end-use certificates was substantiated as detailed in finding C. Although the delays in the processing of the End-Use Form 1822 are having a negative effect on the commercial venture program and the small business customers of Government Liquidation, privatization of the program did not cause the problem. The requirement for end-use certificates for certain property sales is not restricted to commercial venture arrangements, and the problem would exist if DRMS were still marketing the items.

Issue 5. Catalogs

The complainant alleged that it was difficult to obtain hard copies of sales catalogs and that the catalogs often contain “incomplete, insufficient, and inaccurate data.”

Audit Results. Although paper sales catalogs are not as readily available as they once were, catalogs are still available, and the effect of the lessened availability on small businesses would probably be the same if DRMS were still handling the sales. Government Liquidation emphasizes the use of its Web site to promote competition and to produce the highest rate of return. The DRMS Small Business Representative stated that because of the paperless initiatives of the Government, DRMS would also have stopped issuing hard copy catalogs if the commercial venture program had not started. In addition, DRMS personnel stated that some of the information DRMS provides Government Liquidation is not accurate. Sales catalogs are available for download from the Government Liquidation Web site, and Government Liquidation personnel stated that catalogs could be obtained by fax, mail, or pick-up during the preview period for sealed bid sales.

Issue 6. Buyer's Premium

The complainant alleged that, "Government Liquidation is adding a 10-percent buyer's premium to each sale, excluding only negotiated sales and term contracts." The complainants question this practice because they never paid a buyer's premium when purchasing surplus parts from DRMS and feel that Government Liquidation is not merely occupying the role of a commercial auctioneer and should therefore not be allowed to charge the premium.

Audit Results. The allegation has no particular adverse effect on small businesses. Although it is true that Government Liquidation does add a 10-percent buyer's premium to sales, the requirement is not restricted to small businesses. DRMS receives the same percentage of the premium (78.2 percent) as they do of the base amount of the sale.

Issue 7. Sales Tax

The complainant alleged that, "Government Liquidation is charging successful bidders sales tax on their purchases." The complainant finds this practice objectionable because they are forced to pay a substantial amount in sales tax without information as to what authority Government Liquidation has for imposing and collecting the money. In addition, many NAACS members purchase surplus material with the intent of reselling the material later and feel that they should be exempt from paying a sales tax.

Audit Results. The allegation has no adverse effect on small businesses. Although it is true that Government Liquidation charges sales tax on each nonexempt sale, Government Liquidation is required to do so, handles the funds collected correctly, and remits to the appropriate jurisdiction the sales taxes collected. Under its Terms and Conditions section, Government Liquidation states that the seller is obligated to collect sales tax and that the buyer must provide documentation for claiming an exemption. Government Liquidation honors exemptions when buyers submit appropriate documentation. Government Liquidation charges sales tax because each sale can be traced to an established site from which inventory is sold that requires the sale taxed according to state and local tax regulations.

Conclusion

Overall, the commercial venture program does not appear to have an adverse effect on small business activity. A contracted study concluded that the CV1 contract had no negative effects on small businesses, and we determined that out of Government Liquidation's reported top 30 customers, at least 27 were small businesses. According to the DRMS small business representative, although greater exposure on the Internet may have lessened the previous advantage of some small businesses located near disposal facilities, overall the exposure has made the excess material available to a greater number of small businesses. Although the allegations pointed to some conditions that needed correction, we do not believe the conditions would affect small businesses differently from other businesses.

Appendix C. Contractor Perspective on the Commercial Venture Program



November 17, 2003

Ladies and Gentlemen:

Liquidity Services, Inc. ("LSI") is very proud to serve as the exclusive partner to the U.S. Defense Reutilization Marketing Service (DRMS) under the Commercial Venture ("CV") program to manage the receipt, storage, marketing and sale of all non-hazardous, usable military surplus through its special purpose subsidiary, Government Liquidation, LLC ("GL").

The CV Program is a net proceeds sharing joint venture that aligns the interests of the CV partner with the Government, since the contractor's sole compensation is paid out of the net proceeds generated (i.e. sales proceeds net of direct costs). The contractor bears 100% responsibility for the working capital advances and the risk for any operating losses under the program. **The CV structure provides a powerful incentive for the commercial partner to both minimize costs and maximize revenues independent of any Government monitoring programs.**

As the CV partner since June 2001, LSI has enabled the Government to realize significantly higher cash returns for surplus property due to its innovative business model, technology platform and value added services. Financial results of its operating strategy have been very positive for the U.S. taxpayer, despite a challenging environment:

- GL has averaged a **55% higher gross rate of return** during the initial two years of its contract versus historical DRMS results (1997 through 1999) prior to the CV program. This outperformance has strengthened over time.
- During fiscal year 2003, GL generated an **80% higher gross rate of return and a 63% higher net rate of return** (net of direct costs) versus historical DRMS results for the same property in the final full year (1999) prior to the CV program.
- GL has **exceeded by 47% the Government's original forecast of net cash distributions to the DRMS** included in the Invitation for Bids for its contract.

This financial performance is more remarkable, considering: (i) the annual volume of DOD surplus items sold has declined by 70% from fiscal year 1998 to 2003, (ii) the quality of property has deteriorated over time, (iii) sales tax must be collected from buyers under the CV program where previously there was no sales tax due, and (iv) the negative effects of 9/11 on our business. As the CV partner, LSI plays an important ongoing role, including:

- **Fiduciary Oversight.** LSI is a leading provider of comprehensive asset recovery services and operates multiple business units in the United States and abroad. At no cost to the Government, LSI monitors the CV program's financial performance and business strategy to ensure net proceeds are maximized.
- **Research and Development.** LSI continuously funds the research and development of marketing and sales technologies to support its market leadership in the disposal of surplus property. LSI exports the most promising of these business practices directly to the CV program, at no cost to the Government, to ensure that it keeps up with the rapid pace of technology advancement to achieve optimum results. **For example, LSI has donated its online auction and sales platform, account management and marketing tools to the CV program, saving the Government over \$5 million of costs and several years of development time.**

We look forward to continuing to serve our Government partner through the ongoing success of the CV program.

Sincerely,

A handwritten signature in black ink that reads "Will P. Angrick".

William P. Angrick, III
Chairman and Chief Executive Officer

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Under Secretary of Defense (Comptroller)/Chief Financial Officer
 Deputy Chief Financial Officer
 Deputy Comptroller (Program/Budget)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
 Director, Defense Logistics Agency Criminal Investigations Activity
 Commander, Defense Reutilization and Marketing Services

Non-Defense Federal Organization

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations

Senate Subcommittee on Defense, Committee on Appropriations

Senate Committee on Armed Services

Senate Committee on Governmental Affairs

House Committee on Appropriations

House Subcommittee on Defense, Committee on Appropriations

House Committee on Armed Services

House Committee on Government Reform

House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform

House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform

House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Honorable John W. Warner, U.S. Senate

Honorable John M. McHugh, U.S. House of Representatives

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FORT BELVOIR, VIRGINIA 22060-6221

IN REPLY
REFER TO J-308

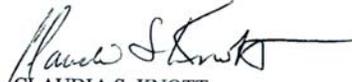
OCT 21 2003

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,
DEPARTMENT OF DEFENSE

SUBJECT: DoDIG Draft Report on "Defense Reutilization and Marketing Services
Commercial Venture Contracts for Privatization of the DoD Surplus Sales
Program" Project Number D2002CH-0030

The Defense Logistics Agency's comments to the subject draft report are attached.

The point of contact is Mr. Michael Stubblebine, Disposition Management Division,
703-767-1537 or Ms. Sharon Nelson, Internal Review Office, 703-767-6267.


CLAUDIA S. KNOTT
Deputy Director
Logistics Operations

Attachment

DLA Narrative Response
to
DoD IG Draft Report
Project No. D2002CH-0030

The DoD IG team of auditors summarizes the objectives of this audit as follows (numbering and emphasis added):

“Our overall objective was to *(1) evaluate whether the DRMS commercial venture contracts* for privatization of the DoD surplus sales program *were providing the best value for DoD*. A secondary objective was to *(2) evaluate whether privatization of the program had adversely affected small businesses* that purchase, sell, and operate military surplus aircraft parts businesses. We also *(3) reviewed the management control program* as it related to the overall objective.”

The following addresses these objectives in broad terms.

Question 1. Do the DRMS CV contracts provide the best value for DoD?

The term *best value to the Government*, when used in a contracting environment, has very specific application and carries with it some specific connotations and expectations. The term applies in the procurement environment governed by the Federal Acquisition Regulation (FAR). It represents a positive approach to making contract awards by allowing for the establishment and weighting of a set of selection criteria (e.g. price, experience, performance history, capacity) as the basis for contract award decisions. This is a very desirable and flexible approach that can result in decisions which are in the best overall interest of the Government. Because of its attractiveness, the auditors apply the *best value* concept and terminology repeatedly throughout to support the conclusion that the decision to enter into Commercial Venture (CV) contracts was not the best decision DRMS could have made. While tempting, because ultimately we are all trying to make the best decision for the DoD, the *best value* approach is inappropriate when applied to this case. DRMS fulfills the commercial sales part of its property disposal mission not in a procurement contracting, but in a sales contracting environment. As such it is bound by the requirements not of the FAR, but by the Federal Property Management Regulation (FPMR, now being rewritten as the Federal Management Regulation (FMR)). That regulation places price, not cost, at the top of the selection criteria. In other words, unless a bidder is disqualified from award for other reasons, (e.g. not responsive or responsible) award is made on the basis of highest price bid.

The following is offered in response to specific points made by the IG.

Contractor Selection Criteria: With respect to how the CV partners were selected, the audit observes that contract award criteria and contract award decisions “did not consider contractor costs and ultimately, the total return to DRMS”.

While a more comprehensive set of selection criteria to achieve the *best value to the Government* could well have been more desirable, the CV contract is a sales contract made under the FPMR/FMR which does not permit consideration of contractor costs in making award decisions. However, as the audit recommends, DRMS is preparing a legislative proposal to address this question.

Financial Results of the Commercial Venture Program: The audit concludes that the *commercial venture program did not improve DRMS performance or achieve the anticipated financial projections for disposal of DoD surplus sales.*

There are several points to be made here.

Rate of Return (RoR): While it is true that DRMS' pre-CV gross rates of return on sales were higher than those subsequently achieved by the CV1 partner in the first years, it is also true that by the time of CV1 award the DRMS rates on its own sales were dropping (2.54% to 2.16% from 1997 to 1998 per audit figures) and that the CV rates are rising (█% to █% from 2000 to 2003 per the audit figures). In fact, the most current data show that the CV2 partner is now achieving an overall RoR of █%.

The drop in DRMS' performance over the last years that it conducted its own sales is attributable to the steadily decreasing quality of property becoming available for sale. In the early and mid-1990s DRMS was receiving large quantities of property from the drawdown of the military services and the closing of installations. As this property stream dried up and as the military services improve their property management practices, less and less A and B condition property makes its way into the disposal system. That trend continues and is part of what both CV partners had to cope with. By now, fully 75% of the property the CV2 partner receives from DRMS is in F, G, or H condition.

Given this fact, the CV2 partner has done well to increase the amount of gross proceeds achieved, as well as improving the overall rate of return over time so that by the third quarter of 2003 it has reached █%. This is better than DRMS was doing when CV started, despite the decreasing quality of the property.

CV1 / CV2 Performance: At the time DRMS entered into the CV1 partnership, it had no previous experience with such a project. CV1 was a test of the CV concept. It was a learning experience for DRMS, conducted on a limited number of Federal Supply Classes (FSCs) and run in parallel with the established DRMS sales program. For DRMS this parallel operation meant it was handicapped in its ability to realize rapid savings from infrastructure reductions. It was not until CV2 bought out CV1 that real personnel savings became possible. Even so, DRMS managed its personnel reductions by attrition, a slow process that realizes savings only slowly. DRMS thereby avoided the dislocations, personal hardships, and additional costs that a more rapid staff reduction via RIFs would have entailed.

CV1 Contract Performance Metrics Results: The audit observes that DRMS did not elect to terminate the contract, as it might have, even though contractor did not meet performance targets. As noted, CV1 was a new undertaking for DRMS. Without a

Darkened areas of this page represent contractor proprietary data that has been deleted.

Deleted

performance history to reference, a number of assumptions had to be made. CV1 performance projections were based on DRMS' own historical property generations data and the assumption that similar property would be available for the contractor to sell under the contract. Projections based on past performance are not always accurate. During the time of the CV1 contract several developments adversely affected what the contractor had to work with. For one, the military services were given "Exchange or Sale" authority as a new means of disposing of property which would otherwise have come to DRMS for disposal through the CV contract. This property included such lucrative items as machine tools, construction equipment, and naval small craft. By diverting property from the normal disposal stream "Exchange or Sale" adversely affected the potential for CV1 performance.

In addition, because CV1 was given property from only a limited number of FSCs, the contractor's fixed costs had to be apportioned over lower potential proceeds. CV2, with its much larger number of FSCs, enjoys a much larger base over which to spread fixed costs, and is doing better than its predecessor. Finally, CV1 was impacted by the other factors which also impact CV2 and DRMS business generally. That is, both the acquisition value and condition of property DRMS can make available for sale are on the decline.

In the end DRMS chose not to terminate the CV1 contract. Despite its shortcomings, CV1 was still a vehicle to achieve the objective of shrinking DRMS and transferring non-governmental functions into the private sector.

CV1 was a learning experience that even in its time represented only about twenty percent of DRMS' disposal sales volume. The focus now is on the success of CV2, which covers one hundred percent of the DRMS usable Demil A, B, and Q property in the United States. Consolidating that flow into a single sales program with a single contractor has made it possible for DRMS to both meet its staffing and downsizing targets and still reap the growing profits from sales.

CV2 Contract Performance Metrics Results: The audit notes that because the CV2 performance metrics do not consider contractor costs as one of the performance measures, "the contractor could have costs about equal to the proceeds from sales, and DRMS would get little or nothing beyond the initial payment" while "such an outcome would not be grounds for DRMS to terminate the arrangement."

Again, it is important to keep in mind that the primary purpose of privatizing the DRMS sales function was the transfer of non-governmental functions to the private sector. Any company that takes over such functions must have the capacity to perform. That takes staffing, which will always be the largest portion of the contractor's cost. This is not to take issue with the desirability to keep costs down, but the CV contract is already structured to achieve this end. The commercial venture partnership was specifically structured to align the interests of both partners, the Government and GL and to ensure that the profit motive works in the best interest of both. Because they share in the profits, both the Government and GL have an interest in reducing costs and increasing revenues.

The CV2 partnership has produced impressive revenues and rates of return in excess of what DRMS achieved on its own. Revenues in FY02 and FY03 (through July) were \$ [REDACTED] and \$ [REDACTED] on property with acquisition value of \$ [REDACTED] and \$ [REDACTED], respectively. After expenses, that produced net cash distributions to DRMS of \$ [REDACTED].

Darkened areas of this page represent contractor proprietary data that has been deleted.

and [REDACTED]. Is this lower than what DRMS made in 1999, its last year of pre-CV2? In absolute numbers, yes. But as percentages of acquisition cost, both sets of figures compare very well with the sales revenues of [REDACTED] and after-expense net proceeds of [REDACTED] that DRMS earned in its last year pre-CV2 on property with [REDACTED] in acquisition value. In other words, GL achieved gross rates of return of [REDACTED] in FY02 and [REDACTED] in FY03 to date. Both are significant improvements over the [REDACTED] DRMS last achieved. The same improvement ([REDACTED]% FY02 and [REDACTED]% FY03 to date for GL) shows up when comparing after-expense performance (0.71% for DRMS). Even in 2001, its ramp-up year, GL achieved a [REDACTED] gross rate of return.

Commercial Venture Program Costs: According to Table 2 of the audit report, for 1997 DRMS' costs for both CV1 and CV2 property were \$41.7M. It also shows that for 2003 total program costs are down to \$34.1M, a reduction of \$7.6M or 18%. That number may look even better, depending on what is covered in the \$8.6M "other costs".

In summary, GL is performing very well. The revenues they generate are steadily climbing, and their costs are dropping. These results are all the more impressive given that both quantity and acquisition value of the property they receive from DRMS are dropping, that fully seventy-five percent of this property is in F or H condition, and that DRMS has removed significant portions of high return property (uniform clothing items with infra-red protective characteristics) from the property stream for reasons beyond the contractor's control.

GL has enormous operating leverage that can be further profitably tapped to the benefit of the US Government. Its Internet auction business model is extremely flexible. It can respond quickly and economically to both temporary surges and permanent shifts in workload. The volume of property DRMS makes available for sale could increase significantly without proportionate increases in operating costs for GL.

As recently demonstrated to DRMS management, Liquidity Services, Inc. (LSI), GL's corporate parent, provides significant added value to both GL and the US Government, and does so at no additional cost to DRMS. At its corporate birth, LSI equipped GL with the software platform on which its Internet auction business model rests. LSI continues to maintain, refine, and expand that platform. All its corporate offspring, including GL, benefit from this investment at no cost to any of them. As a profit-sharing partner, DRMS also benefits.

As part of its corporate strategy and planning, LSI maintains active market research, technical innovation, marketing, and public relations programs. Through its interconnected Web sites, LSI brings the benefits of corporate branding and broad buyer exposure to all its corporate components. All of them, including GL, benefit from this investment at no cost. Again, the US Government also benefits.

In assuming title to all property DRMS sends its way, GL performs another valuable function in the CV partnership that the audit does not address. GL relieves the US Government of significant risk legally, operationally, and financially. GL assumes all risk of loss and decline in value of property before resale. With each up-front payment, GL assumes the responsibility for all follow-on expenses for both field and support staff, property marketing and sale, as well as supporting office and other expenses. In doing

Darkened areas of this page represent contractor proprietary data that has been deleted.

Revised

so, GL and LSI make a significant capital investment without which it would not have been possible for DRMS to withdraw from operating its own sales program. Finally, as part of its own management oversight function and responsibility, LSI provides a service to the US Government in controlling and guiding GL through the application of its own performance metrics and the exercise of its fiduciary oversight. In addition, LSI retains the nationally recognized accounting firm of Ernst and Young to audit not only its own, but also GL's finances. In the process, LSI ensures that GL's operating costs are kept as low as possible, a direct contribution to the profitability of the CV program.

Question 2. Has privatization of the DRMS sales program adversely affected small business?

The audit concludes that:

“Overall, the commercial venture program does not appear to have an adverse effect on small business activity. A contracted study concluded that the CV1 contract had no negative effects on small businesses, and we determined that out of Government Liquidation's reported top 30 customers, at least 27 were small businesses.”

Question 3. How effective is the DRMS management control program as it relates to the overall objective.

In looking at DRMS' management controls over the CV program, the audit focuses almost exclusively on costs. It faults DRMS for assuming a part of the one-time merger and acquisition costs resulting from the CV2 partner's takeover of the CV1 partner. The audit also looks at the CV contractors costs, finding that DRMS is not sufficiently involved in containing these. Finally, it takes issue with DRMS' own costs, finding that they have not come down quickly enough.

CV1 / CV2 merger costs:

When GL bought out the CV1 contract, DRMS assumed its part of the resulting one-time costs. The audit holds that these costs would have been avoided if the CV contract had been subject to the provisions of the FAR instead of the FPMR. However, since the FAR did not apply, the SCO correctly allowed them, in accordance with the 80%/20% split provided for in the CV2 contract.

Control Over Contractor Costs: Because CV2 prohibits DRMS from selling applicable items to anyone except GL, the audit likens the CV2 contract to a non-competitive procurement and proposes a higher level of surveillance over contractor costs. Without taking issue with the desirability of low contractor costs, an increased level of surveillance will serve only to drive DRMS' own costs up, which is neither desirable nor necessary. The commercial venture partnership was specifically structured to align the interests of both partners, the Government and GL, and to ensure that the profit motive works in the best interest of both. Because they share in the profits, both the Government and GL benefit from reduced costs as well as from increased revenues.

Existing Controls / FAR Applicability to Largest Cost Category: The audit makes the point that the contracting officer and DCAA alternately monitor the reasonableness of contractor direct costs. It goes on to assert that these reviews have not “contained adequate examination of costs for reasonableness”. The main basis for the criticism appears to be that, as a sales contract, the CV contract and its administration are not subject to the standards of the FAR. The audit does not, however, offer specifics or assert that any of the costs have actually been unreasonable.

DLA Response to Recommendations in DoD IG Draft Report, Project No.
D2002CH-0030

A.1: Establish adequate controls over contractor costs for the commercial venture program similar to those in the Federal Acquisition Regulation (FAR).

RESPONSE: Partially concur. Defense Reutilization and Marketing Service (DRMS) is in the process of developing a review team to conduct audits of the commercial venture contract. Specifics to be reviewed will be Government Liquidation's (GL's) controls and policies for purchasing supplies and services, and their controls for employees seeking reimbursement for expenses.

In addition, the IG expresses concern about payroll costs in that GL has no formal compensation plan. An initiative of the DRMS review team will be to audit GL's practices in determining the level of compensation for their employees, to include bonuses and awards. The FAR states that compensation practices should conform with that of like firms; therefore, the practices of like companies will be reviewed to determine practices and compare them to GL. Past audit results have been reported to GL as well as DRMS. The new DRMS review team's results will also be reported to GL's parent company, Surplus Acquisition Venture (SAV), since they too have a vested interest. The thought behind this is that, in instances where DRMS does not have authority to change GL's practices, SAV could make the adjustments.

A.2: Prepare a legislative proposal enabling the use of a best-value approach in the award of sales contracts and submit to Congress.

RESPONSE: Concur. A legislative proposal amending the Federal Property and Administrative Services Act of 1949 has been forwarded to the Defense Logistics Agency (DLA) for submission to Congress. The proposal amends the Act to allow for a best-value approach in the award of surplus property under DRMS sales contracts.

A.3: Determine how the selection criteria for the follow-on contract will consider contractor costs and preclude any future payment of merger and acquisition costs.

RESPONSE: Partially concur. The selection criteria used in Commercial Venture (CV) 1 and CV2 grew out of the fact that both were essentially sales solicitations subject to the Federal Property Management Regulations (FPMR, now being rewritten as the Federal Management Regulation (FMR)). Those regulations place price, not cost, at the top of the selection criteria. This audit observation appears to view the CV solicitations as if they were subject to FAR requirements.

It is important to remember that the CV arrangement was set up as a partnership. As structured, part of that partnership is sharing in the costs. To the extent that a follow-on CV partnership involves new one-time merger and acquisition costs, DRMS will examine those costs and determine to what degree it is appropriate for the Government to share in

Revised

them. It should also be noted that, while it is possible to require the next CV partner to bear all merger and acquisition costs alone, doing so may well limit the number of firms capable of or interested in participating and could well be counter-productive from the Government's point of view. It is also possible to structure the next CV partnership in a manner so as to avoid the question of contractor costs entirely. DRMS could for instance, require a percentage of the gross revenues instead of the net revenues as its share of the sales proceeds. This is the approach favored in the franchising industry. It has several advantages. First among them is simplicity. It eliminates the need to track or evaluate contractor costs because the contractor covers them out of his share of the proceeds as his cost of doing business. The profit motive continues to operate and remains the incentive for the contractor to keep his costs low. In fact, because the Government no longer subsidizes part of the contractor cost, that incentive may even become stronger. DRMS will consider the question of contractor cost carefully when the next solicitation is prepared.

A.4: Develop new contractor performance metrics that evaluate factors such as revenue, costs, return on sales, and total income similar to other commercial businesses to effectively judge the success or failure of the commercial venture program.

RESPONSE: Partially concur. Contractor performance metrics evolve as a result of experience with previous metrics. This was the case between CV1 and CV2. It will also be the case between CV2 and any follow-on arrangement. In developing the performance metrics for future CV follow-on arrangements, factors such as those recommended by the auditors will be incorporated as far as possible. There is a link, however, between performance metrics and contract award criteria, which in turn are determined by the regulatory environment in which the contract is awarded. As noted in the response to recommendation A3 above, the CV contract falls under the FPMR/FMR, which makes price the first consideration in the contract award decision. That makes other award criteria secondary at best. In response to another recommendation of this audit (A2) DRMS is addressing the desirability of weighing other factors by preparing a legislative proposal enabling the use of a best-value approach in the award of sales contracts. With expanded award criteria the development of related performance criteria becomes much easier and more meaningful. DRMS will pursue this approach and this recommendation will receive careful consideration when the next solicitation is being prepared.

A.5: Determine whether the commercial venture is achieving desired goals and results and whether the program should be terminated and other alternatives explored.

RESPONSE: Concur. In examining the results achieved by the CV partnership the audit focuses exclusively on the financial results. While these are important, the original decision to initiate such a partnership was a political and policy decision to move what were identified as non-Governmental functions into the private commercial realm. The goal was to cut DRMS' size and labor cost, and to help make DRMS as financially self-sufficient as possible. By achieving that goal, CV has unquestionably been successful. Although providing the best attainable value for the Government is part of any contracting action, other factors may outweigh financial considerations. In this case,

maintaining the status quo that existed prior to conversion to CV was not an option. In addition, the conversion process, once started, became increasingly difficult to reverse as DRMS progressively lost the personnel with the knowledge it would have taken to return the surplus sales function to Government operation. By the time CV1 ended and CV2 took over, such a return was virtually out of the question. DRMS remains committed to the success of CV in both the policy and financial sense. DRMS works with and oversees its current CV partner to help him achieve the best possible return on investment to the Government. Given the continuing decline in the quantity, value, and condition of the property coming available for sale, that is a challenge. Under the circumstances, the current CV partner is doing quite well. His rate of return is trending steadily upward and his costs are declining. In structuring any follow-on arrangement to the current CV partnership, DRMS will carefully consider all its options.

B.1: We recommend the Director, Defense Logistics Agency issue guidance that implements a standard material recoupment program, such as the Automated Asset Recoupment Program, at Defense supply centers.

RESPONSE: Concur. A standard automated recoupment program is being designed for DLA's Business Systems Modernization effort. The recoupment function is expected to be available in calendar year 2005.

B.2 We recommend the Commander, Defense Reutilization and Marketing Service, Defense Logistics Agency:

a. Issue guidance for screening new or unused property items with demand requirements against backorders, open contract orders, and open purchase requests and notify customers property when items are available.

RESPONSE: Partially concur. Guidance for screening items for re-issue within DoD is already well-established and can be found in DoD 4160.21-M, Chapter 5, paragraph B. "All excess and FEPP shall be made available for screening before donation, sale, or other disposal action unless specifically excluded by special processing instructions...". As far as ensuring that existing DoD requirements are met from existing stocks, including property available from the DoD property disposal system, it is the requisitioner's responsibility to screen for available assets and to submit automated MILSTRIP requisitions to recoup them, where appropriate. DRMS' responsibility is to process requisitions in a timely manner to meet issue priority groups (DoD 4000.25-1-M, Chapter 2. 2. 1). We suggest that, instead of calling for new guidance, the audit might more appropriately recommend process improvements to make available DRMS assets more visible for screening. For example, under the Disposal of New or Unused Property Items the audit does not focus on items potentially batched versus non-batched items. All items over \$800 are processed as single line items and are made available to customers through the Reutilization Screening process. Items \$800 and less are potential candidates to be batched and not made available for electronic screening or "want list" matches. DRMS is currently testing the matching of DLA Inventory Control Point Want Lists for items \$800

and less (A1-A4 condition) against Generator Pre-Receipt/Due-In notices to support the ICP backlog reduction. The target date for the completion of the test results is February 2004.

b. Instruct that the sales contracting officer negotiate with the contractor modification of contract 99-0001-0002 to include screening new or unused property items for demand and resale to DoD.

RESPONSE: Nonconcur. The GL contract already has provisions for DRMS to withdraw items from GL sales if a valid US Government requirement is documented. For DRMS to dictate a contract modification for the purpose the IG proposes would distort the incentives that the CV contract is built on, compelling GL to sell noncompetitively to DoD entities items that they have heretofore sold competitively on the open market. CV was designed as a risk- and reward-sharing, public-private partnership that would free the CV purchaser from the policy constraints that DRMS sales operations were forced to operate under and would encourage best business practices.

Moreover, there is nothing to stop GL from selling items back to DoD now. DoD supply activities can search the GL Website for items on sale that could be used to fill backorders or offset new procurement, and bid for these items along with other participants. In order to assure that CV incentives remain intact, however, and that GL (and DRMS) receives a competitive return, these should be carried out in a market-based environment, and not as the result of Government intervention.

C: We recommend that the Director, Defense Logistics Agency Criminal Investigations Activity (DCIA), accelerate elimination of the backlog for unprocessed end-use certificates as well as prevent any future backlogs.

RESPONSE: Concur. The report noted that, as of March 27, 2003, 387 End-Use Certificates received from GL were pending processing and 130 of those had been pending for more than 90 days. The report noted that the number of End-Use Certificates pending processing for more than 90 days had decreased from 289 on January 13, 2003 to 130 on March 27, 2003. As of September 26, 2003, DCIA had only 68 End-Use Certificates pending and only five of these were over 90 days old. Each of the five represents a prospective buyer on whom derogatory information has been identified. DCIA processes between 70 and 217 clearances a month.

D.1: Monitor the dollar level of reported noncompetitive and reduced-competition sales for any significant increase.

D.2: Include the noncompetitive and reduced-competition sales as a category in Defense Reutilization and Marketing Service and Defense Contract Audit Agency reviews of the CV program.

Darkened areas of this page represent contractor proprietary data that has been deleted.

RESPONSE: Concur. While GL's noncompetitive/reduced-competition sales are a minor part of GL's business (less than █% for June 03 or \$█ of their \$█ revenue), we will add this as an initiative that the DRMS review team will audit.

D.3: In the solicitations for any future commercial venture contracts, express a preference for fully competitive sales and specify some minimum documentation and approval requirements for any contractor sales where competition is restricted.

RESPONSE: Nonconcur. The audit addresses a complaint from the Small Business Association and makes this recommendation in response. It is important to remember several things. First, even when DRMS was conducting its own sales, the Sales Contracting Officer always had the authority to conduct sales under other than fully competitive conditions when necessary. Second, one of the reasons for moving the sales function into the private sector in the first place was to take advantage of the contractor's ability to apply best business practices to sales. While these probably involve full competition in most instances, that may not always be the case. Here the profit motive works on behalf of both the Government and the CV partner. The audit takes note of this fact by finding that the volume of sales with less than full competition has in fact declined, both between CV1 and CV2 and also within CV2 over time. As part of its general oversight function, DRMS will look at the volume of non-competitive sales, but believes that as a matter of policy, the contractor's hands should not be tied unless it can be demonstrated that he is consciously acting against the best interest of the Government.

E: We recommend the Commander, Defense Reutilization and Marketing Service, Defense Logistics Agency direct that Government Liquidation stop making payments to the financial advisor, effective June 13, 2006.

RESPONSE: Concur. Two joint ventures were formed as a result of DRMS' financial advisor contract with Kormendi-Gardner Partners (KGP). These were CV1 and CV2. In accordance with contractual language that provides for contractor compensation for a period of five years commencing on the date of each joint venture formation, KGP was notified that compensation for property awarded under CV1 ceased on July 13, 2003, as the contract was awarded on July 14, 1998. They were also notified that compensation for property awarded under CV2 will continue through June 12, 2006, as that contract was awarded on June 13, 2001. KGP has hired Legal Counsel and has taken issue with the five year limitation on compensation from sale of CV 1 and CV 2 property and claim they are entitled to payments for the entire period of the CV 2 sales contract. The legal issues raised by KGP are being reviewed by DRMS. The results of this review may change the concurrence to this recommendation.

Team Members

The Contract Management Directorate, Office of the Deputy Inspector General for Auditing of the Department of Defense prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

David K. Steensma
Robert K. West
Henry F. Kleinknecht
Anella J. Oliva
Tyler C. Apfel
Rebecca L. Yovich