Audit Report

FINANCIAL IMPACTS OF DEFENSE LOGISTICS AGENCY ELECTRONIC CATALOG AND OFFICE SUPPLIES INITIATIVES ON RETAIL LEVEL PURCHASING

Report No. 99-184

June 11, 1999

Office of the Inspector General
Department of Defense

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Acronyms

CRR	Cost Recovery Rate
DLA	Defense Logistics Agency
DVD	Direct Vendor Delivery
E-CAT	Electronic Catalog
GSA	General Services Administration

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June 11, 1999

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF DEFENSE (LOGISTICS)
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Financial Impacts of Defense Logistics Agency Electronic Catalog and Office Supplies Initiatives on Retail Level Purchasing (Report No. 99-184)

We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Deputy Under Secretary of Defense (Logistics) comments conformed to the requirements of DoD Directive 7650.3; therefore, additional comments are not required. The Defense Logistics Agency comments were partially responsive. We request that the Defense Logistics Agency provide additional comments on Recommendations 2a., 2b., and 2c. by August 10, 1999.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Tilghman Schraden at (703) 604-9186 (DSN 664-9186) (tschraden@dodig.osd.mil) or Mr. Terry Wing at (215) 737-3883 (DSN 444-3883) (twing@dodig.osd.mil). See Appendix E for the report distribution. Audit team members are listed inside the back cover.

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Report No. 99-184 **June 11, 1999**
(Project No. 8LD-0040)

Financial Impacts of Defense Logistics Agency Electronic Catalog and Office Supplies Initiatives on Retail Level Purchasing

Executive Summary

Introduction. This report is the first in a series of reports on retail level purchasing practices. In response to DoD efforts to reduce inventories and increase the use of commercial distribution systems, the Defense Logistics Agency (DLA) has implemented best commercial inventory initiatives for the acquisition and distribution of military requirements. DLA expects the initiatives to transform its methods of procuring materiel into advanced private sector business practices. Among other benefits, the transformation should provide retail level organizations lower pricing as a result of the DLA leveraged buying power. DLA initiatives included an electronic catalog ordering system (April 1997) and a blanket purchase agreement for office supplies (October 1998) issued against a General Services Administration Federal supply schedule. Retail organizations procuring material through those initiatives paid DLA a cost recovery rate (percentage of the price of materiel ordered) for administering the initiatives. The FY 1999 rate for the electronic catalog and blanket purchase agreement for office supplies was 7 percent and 4.8 percent, respectively. Orders for the electronic catalog products from April 1997 through January 20, 1999, were $553,000, and FY 1999 sales for office supplies are projected to be $2.9 million.

Objective. The overall audit objective was to determine whether retail level organizations in DoD were using the most economical and efficient source of supply when purchasing commercial brand name items through centralized Federal procurement programs. The specific objective of this report was to evaluate the financial impact of the electronic catalog and office supplies initiatives on retail organizations for materiel ordered through those initiatives. We also included a review of the management control program as it applied to the specific audit objective.

Although the DLA electronic catalog is accessible through the DoD electronic mall initiative, we did not include an evaluation of the electronic mall initiative in the scope of this audit.

Results. Retail organizations generally procured items through the most economic and efficient centralized Federal procurement program (Appendix C). We also commend DLA for implementing commercial inventory practices such as the electronic catalog and office supplies initiatives. However, the DLA process for developing cost recovery rates for the electronic catalog and office supplies initiatives needed improvement to ensure that the rates were properly computed. The DLA system used to bill customers and pay vendors for materiel ordered through the electronic catalog also needed improvement to ensure that customers were billed and vendors were paid.

As a result, cost recovery rate charges were inaccurate and DLA did not have the cost data required to evaluate the effectiveness of the electronic catalog program. Additionally, retail organizations sometimes paid higher prices than if the same items were ordered directly from vendors, and customer billings and vendor payments were not made promptly.

The management controls could be improved. We identified a material weakness in the process used to bill customers and pay vendors. See Appendix A for details on the management control program.

Summary of Recommendations. We recommend that the Deputy Under Secretary of Defense (Logistics) issue guidance to the Services to reemphasize that the Defense Reform Initiative and the Defense Federal Acquisition Regulation Supplement provide authority for organizations to buy goods directly from vendors instead of processing requests through Government procurement offices, when the vendors offer the best value in cost, quality, and timeliness. We recommend that the Director, DLA, establish controls to ensure that cost recovery rates are properly computed and analyzed for effectiveness, and that customers are billed promptly and vendors are paid for materiel ordered through the electronic catalog.

Management Comments. The Deputy Under Secretary of Defense (Logistics) concurred with the recommendation to issue guidance on buying goods directly from vendors. The Deputy Under Secretary issued a memorandum to the Military Departments reminding them that they had substantial authority to purchase centrally managed items from other sources, when those sources provide the best value. DLA partially concurred with the recommendations to develop a system to accumulate costs to properly develop cost recovery rates and to establish controls to ensure that customers were promptly billed and vendors paid. DLA stated that costs are tracked and that a vendor has been tasked to assist in projecting sales data. Additionally, the billing and payment problem was a vendor invoicing problem that has been corrected. DLA nonconcurred with the recommendations to establish procedures to ensure that costs for managing the electronic catalog were not included in other DLA cost recovery rates and to identify the cost drivers for the office supplies initiative using the General Services Administration one percent Federal supply schedule cost recovery rate as a benchmark. DLA stated that no additional cost recovery rate was placed upon items that already had a cost recovery rate established and that the General Services Administration recovery rate alone was not an adequate benchmark. A discussion of management comments is in the Finding section of the report and the complete text is in the Management Comments section of the report.

Audit Response. The Deputy Under Secretary of Defense (Logistics) comments were fully responsive and additional comments are not required. DLA comments were partially responsive. DLA did not identify the system for accumulating cost data for developing and administering the electronic catalog that is needed for determining the cost recovery rate. We disagree that costs associated with the electronic catalog were not included in both the electronic catalog and other DLA cost recovery rates. Also, we continue to believe that the General Services Administration cost recovery rate is the best benchmark available for DLA to use in evaluating the appropriateness of its office supplies initiative cost recovery rate. Therefore, we request that the DLA provide comments on this report by August 10, 1999.

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Background

Introduction. In response to DoD efforts to reduce inventories and increase the use of commercial distribution systems, the Defense Logistics Agency (DLA) has implemented best commercial inventory initiatives for the acquisition and distribution of military requirements. DLA expects the initiatives to transform its methods of procuring materiel into advanced private sector business practices. Among other benefits, the transformation should provide retail level organizations lower pricing as a result of the DLA leveraged buying power.

This report is the first in a series of reports on retail level purchasing practices. The report discusses DLA charges to retail organizations for materiel ordered through two DLA commercial inventory initiatives, the electronic catalog (E-CAT) ordering system and the blanket purchase agreement for office supplies. Those initiatives were discussed in Inspector General, DoD, Report No. 97-205, "Dual Management of Commercially Available Items - Defense Logistics Agency Electronic Catalog Pilot Program," August 15, 1997, and Report No. 98-144, "Dual Management of Commercially Available Items - Information and Imaging Solutions," June 3, 1998. Although the E-CAT is accessible through the DoD electronic mall initiative, we did not include an evaluation of the electronic mall in this review.

DLA Mission. DLA is the central combat support agency that manages supplies in various commodity areas such as clothing, construction materiel, electronic supplies, food, fuel, general supplies, and medical supplies. DLA uses five supply centers to procure supplies. The supply centers consolidate requirements and procure the supplies in sufficient quantities to meet customer needs. Supplies are stored and distributed through a complex of depots or delivered directly to the customers from the vendor through the direct vendor delivery (DVD) program.

DLA Electronic Catalog. In April 1997, DLA initiated an E-CAT pilot program that provided retail organizations on-line capability to order commercially available, common-use items, such as cleaning supplies; office products; and tools for direct shipment from suppliers to the organization. Four retail organizations and seven vendors were included in the pilot program. In January 1998, the catalog was incorporated into the DoD electronic mall[1]. As of January 1999, there were 272 orders, valued at approximately $553,000, placed through the E-CAT. About $540,000 (98 percent) of the value of the orders was submitted by one retail organization.

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[1] The DLA E-CAT initiative and other initiatives are being consolidated into the DoD electronic mall to provide virtual one-stop shopping over the Internet.

DLA Office Products Initiative. On October 21, 1998, DLA established a blanket purchase agreement with a vendor in the General Services Administration (GSA) Federal supply schedule to provide office supplies to DLA customers. A blanket purchase agreement enables organizations to set up accounts with a vendor so that recurring purchases from schedule contracts can be placed and processed with a minimum of time and paperwork. The blanket purchase agreement for DLA included nine Federal supply classes.
Three Federal supply classes were assigned to DLA for integrated materiel management and the remaining six classes were assigned to GSA for integrated materiel management. The supplies in the agreement included such items as binders, computer supplies, diskettes, and paper. DLA combined common supplies into 14 commodity groups and negotiated a discount for each of the groups. FY 1999 sales for office supplies are projected to be $2.9 million.

DLA Cost Recovery Rates. DLA supply centers operate under a working capital fund concept and, therefore, charge their customers a cost recovery rate (CRR) that is applied to the DLA acquisition cost of materiel. The CRR includes costs to run DLA supply centers, overhead costs, and materiel related costs such as inflation and transportation. The CRR is added to the DLA acquisition cost to establish the sales price DLA charges its customers.

Each fiscal year, DLA Headquarters establishes a composite CRR for each of its supply centers. The composite rate multiplied by the estimated annual sales of each center represents the funds that each center is expected to recoup from its sales. The supply centers are permitted to charge customers various CRRs to reflect the different levels of service and support associated with the goods provided. Accordingly, CRRs for DVD items were significantly less than the CRRs for the items that DLA procured for inventory because costs for such things as depot handling and inventory losses are not incurred with DVD shipments. Variable CRRs improve cost visibility for customers and encourage them to differentiate their needs based on costs and mission requirements. Total funds generated from the variable CRRs should equal the funds that centers would have recouped if a nonvariable CRR were charged for all orders.

GSA Mission. GSA, established in 1949 to supply personal property to Government organizations, operates a worldwide supply system to contract for and distribute personal property and services to Federal agencies. GSA provides items to its customers through several supply programs that include Federal supply schedules. Under the Federal supply schedule program, GSA enters into contracts with commercial firms to provide supplies and services at stated discounted prices for a given period. Customers place orders directly with schedule contractors, and contractors deliver directly to customers. The contract price for the materiel ordered includes a one percent GSA CRR. The CRR covers administrative costs to manage the program including costs for market research, procurement planning, solicitation and award of procurement instruments, and contract administration.

Objective

The overall audit objective was to determine whether retail level organizations in DoD were using the most economical and efficient source of supply when purchasing commercial brand name items through centralized Federal procurement programs The specific objective of this report was to evaluate the financial impact of the DLA E-CAT and office supplies initiatives on retail organizations for materiel ordered through those initiatives We also included a review of the management control program as it applied to the audit objective See Appendix A for a discussion of the scope and methodology and the results of our review of the management control program See Appendix B for a summary of prior coverage See Appendix C for the results of the overall audit objective

Cost Recovery Rates, Customer Billings, and Vendor Payments

The DLA process for developing CRRs for the E-CAT and office supplies initiatives needed improvement The system DLA used to bill customers and pay vendors for materiel ordered through the E-CAT also needed improvement. The conditions occurred because DLA:

- inaccurately computed the CRRs,
- did not have a system to identify E-CAT costs,
- provided questionable value added services, and
- lacked adequate controls over customer billings and vendor payments

As a result, CRR charges were inaccurate and DLA did not have the data required to evaluate the efficiencies and effectiveness of the E-CAT Additionally, retail organizations paid higher prices than if the same items were ordered directly from vendors, and customer billings and vendor payments were not made promptly

Guidance

Defense Reform Initiative. The Defense Reform Initiative, November 1997, established best business practices for DoD to follow to revolutionize its business affairs in DoD. One practice is to increase the use of commercial credit cards. The credit card provides a less costly and more efficient way for DoD to buy goods and services directly from vendors instead of processing requests through Government procurement offices. Studies have shown that internal costs are often cut by more than half when a credit card is used instead of a purchase order. By FY 2000, the DoD goal is for the credit card to be used for 90 percent of purchases under $2,500.

Another best business practice is to expand the use of Internet based commerce to order needed supplies. With computer based purchasing, buying decisions are placed in the hands of individual customers who need the products. Customers can access data on products and order directly from the company. Additionally, agencies can develop interactive catalog systems. Internet based commerce also bypasses the bureaucratic process involving individual vendor payment through a Government finance office. Specifically, purchases would incorporate direct vendor payment through the credit card company, thereby reducing the expense of finance office operations. DoD anticipates that this process will save DoD significant processing costs while providing vendors on-the-spot payment.

DoD Logistics Strategic Plan. The 1998 DoD Logistics Strategic Plan is designed to focus the collective attention and resources of DoD on improving logistics support to the customer. Fundamental principles of the plan provide that logistics improvement initiatives focus on process change and incorporate best business practices regardless of the source or the development activity, and unneeded; uneconomical; and redundant logistics process segments will be reduced or eliminated. One objective of the plan is to significantly reduce logistics costs to the customer through simplified improved financial management, billing, and payment processes. Another objective is to ensure that the costs are fully quantified and traceable through processes such as activity based costing. To achieve this objective, CRR costs must be identified and reduction goals must be established.

Defense Working Capital Fund. DLA supply centers operate under the Defense Working Capital fund (the fund). The fund provides a financial framework for more efficient and effective allocation of resources within DoD. The primary goal of the fund is to focus the attention of all levels of management on the costs of carrying out the DoD operations and the management of those costs. Benefits of the fund include identifying the full costs of providing goods and setting rates to recover the full costs of goods and services provided by the fund to make DoD managers aware of those costs. DoD Regulation 7000.14-R, "Financial Management Regulation," July 1998, states that actual costs are to be evaluated against revenues generated and the financial condition of the business assessed accordingly.

Cost Recovery Rates

The DLA process for developing CRRs for the E-CAT and office supplies initiatives and for collecting costs for the E-CAT needed improvement. Additionally, the value that DLA added to aspects of the procurement process for the initiatives was questionable.

E-CAT. The DLA process used to develop the CRR for E-CAT needed improvement because DLA did not have a system to determine the actual cost of establishing and administering E-CAT. Without cost data, DLA could not ensure that retail organizations were properly charged for services provided and could not evaluate E-CAT to make informed management decisions related to controlling costs and determining whether the initiative was meeting the intended goals.

Process Used to Develop CRR. The DLA process used to develop the CRR for E-CAT was unusual. CRRs normally were developed from estimating sales and annual costs, and calculated by dividing the sales into the costs. When the E-CAT was established in April 1997, DLA set the CRR at 7.6 percent. The 7.6 percent was based on the lowest DVD CRR in effect at the Defense Supply Center Richmond. There was no analysis of E-CAT estimated sales and projected costs to calculate the CRR. In October 1998, the DLA Executive Steering Group changed the CRR to 7 percent. That decision also was made without an analysis of E-CAT estimated sales and projected costs. Without estimating E-CAT sales and costs to compute the CRR, there was no assurance that funds recouped through the CRR covered costs or that charges to retail organizations were proper.

The DLA Executive Steering Group could not establish the proper CRR because DLA did not have a system to identify and collect costs associated with E-CAT. Consequently, DLA had no data to evaluate the adequacy of the CRR and the initiative. Without an effective system, retail organizations were being overcharged for services provided. For example, DLA did not exclude E-CAT costs from costs used to calculate CRRs for other programs. As a result, DLA recouped costs to administer E-CAT twice, once in charges to retail organizations for the E-CAT CRR and again in charges to retail organizations for CRRs of other programs, in which E-CAT costs were erroneously included in calculating those CRRs.

Value Added. The value that DLA added to aspects of the E-CAT procurement process was questionable. Retail organizations did not use the E-CAT because they stated the DLA CRR was too high and that materiel could be ordered directly from an E-CAT vendor without ordering through DLA and paying the DLA 7 percent CRR.

Prior Audit. Inspector General, DoD, Report No. 97-205, reported that portions of the E-CAT pilot program duplicated GSA supply programs and items procured through E-CAT could cost customers more than if the same items were procured through GSA. In response to the report, DLA stated that the pilot program was in its infancy and it should be allowed to become fully operational before drawing conclusions on its value. DLA also stated that the National Performance Review permitted competition among Federal agencies, and customers should be provided the right to elect the most suitable combination of price, service, and availability for themselves. On February 13, 1998, as a result of negotiations with DLA, we agreed to conduct a joint survey with DLA to determine whether the E-CAT should contain items also offered by GSA.

As of June 1998, E-CAT cumulative orders were only $172,000. Because of the low dollar value of orders, we concluded that the benefits in conducting a joint survey at that time would be minimal. Therefore, we visited or contacted five organizations, including four organizations that were part of the pilot program, to evaluate their use or nonuse of E-CAT in purchasing items at the retail level.

Customers Included in Pilot Program. Of the four customers in the pilot program, two (Defense Distribution Depot Susquehanna and Walter Reed Army Hospital) did not use the E-CAT because the CRR was too high. The remaining two customers (Fleet Industrial Supply Center, Norfolk, and Wright Patterson Air Force Base) made minimal use of the E-CAT.

Defense Distribution Depot Susquehanna. The Defense Distribution Depot Susquehanna made a business decision not to use the E-CAT. The Distribution Depot placed one order valued at $93 through the E-CAT for one of the vendor's products. After that order, personnel at the Distribution Depot made a business decision to not use the E-CAT because the

CRR that DLA charged was too high. For example, depot personnel ordered materiel directly from the E-CAT vendor (approximately $30,000 a year), paying the same price as the E-CAT but without paying the E-CAT CRR.

Walter Reed Army Hospital. Walter Reed Army Hospital made a business decision not to use the E-CAT. Walter Reed placed three orders, valued at $3,523, through E-CAT during the initial phase of E-CAT. Walter Reed placed no orders since October 1, 1998, because its personnel believed the CRR was too high. Additionally, the E-CAT vendor that Walter Reed ordered materiel from had a branch office located nearby and the hospital could get as good a price as the E-CAT offered without paying the CRR.

Fleet Industrial Supply Center. The Fleet Industrial Supply Center, Norfolk, made minimal use of the E-CAT. The Ship Intermediate Maintenance Activity (serviced by the Fleet Industrial Support Center) placed three orders, valued at $1,824, through E-CAT. Personnel at the Fleet Industrial Support Center believed that the reason for low orders was that E-CAT was not properly marketed to potential customers.

Wright Patterson Air Force Base. Wright Patterson Air Force Base made minimal use of the E-CAT. Wright Patterson placed 35 orders, valued at $1,334, through E-CAT during the initial phase of E-CAT. However, it made no additional orders because the purchasing function was contracted out in October 1998 and the vendor performing the function used its own suppliers.

Additional E-CAT Customer. The Naval Aviation Depot, North Island, was the single largest user of E-CAT and ordered products through the Fleet Industrial Supply Center, San Diego. The Fleet Industrial Supply Center, San Diego, had not evaluated its ordering process for Naval Aviation Depot, North Island, to ensure that the most economical source of supply was used to obtain E-CAT products. E-CAT data that DLA provided in October 1998 showed that, since the start of the program, retail organizations had placed 158 orders, valued at approximately $360,000. The Naval Aviation Deport accounted for $349,000 (97 percent) of the orders and $319,000 (91 percent) were for one vendor's products. Two other E-CAT customers in the pilot program ordered materiel directly from the same vendor to avoid paying the CRR.

We visited personnel at the Fleet Industrial Supply Center, San Diego, to discuss the use of the E-CAT versus ordering directly from the vendor. Supply center personnel stated that the E-CAT was the approved source of supply and they could not continuously order directly from the same vendor for all their tool purchases. The personnel also stated that by using the E-CAT, DLA could provide additional service if there was a problem with a shipment.

We contacted the vendor and were informed that the vendor would provide the same pricing as E-CAT and that the vendor had its own web site for customers to order materiel. Regarding the delivery, service, and quality of E-CAT products, the vendor routinely visited the Depot, and had a branch office within 10 miles of the Naval Aviation Depot.

Sales data as of January 1999 showed that the Naval Aviation Depot had ordered $454,000 of the vendor's products through E-CAT. If the materiel were ordered directly from the E-CAT vendor, the Naval Aviation Depot could have saved approximately $31,800. Defense Federal Acquisition Regulation Supplement 208.7003-1 provides organizations the authority and flexibility to purchase items from sources of supply other than the central supply system when those sources provide the best value in cost, quality, and timeliness. In a February 16, 1999, memorandum, to the Commander, Fleet Industrial Supply Center, San Diego, we requested that the Commander consider ordering materiel directly from the vendor to prevent paying the 7 percent DLA CRR. On March 18, 1999, the Commander responded, stating that electronic commerce initiatives such as the E-CAT, offer advantages beyond pure price considerations. Additionally, the supply center will continue to seek best value solutions when supplying commercial items in support of its customers.

Office Supplies. The DLA process for developing the CRR for the office supplies initiative needed improvement. Specifically, the CRR was calculated incorrectly. Additionally, the value DLA added to aspects of the procurement process was questionable.

Process Used to Develop CRR. DLA used inappropriate data to compute the CRR for the purchase of office supplies by retail organizations. To compute the FY 1999 CRR of 4.8 percent, DLA used estimated annual sales and costs, and excluded about $77,000 in DLA overhead costs. DLA excluded overhead costs because it wanted to make the CRR competitive. Additionally, DLA used estimated annual sales of $5.8 million in the CRR calculation instead of the $3.2 million that was negotiated with the vendor selected to provide the supplies. As a result, the 4.8 percent CRR was calculated incorrectly.

Value Added. The value DLA added to aspects of the office supplies procurement process was questionable. In some instances DLA was able to negotiate better prices than GSA; however, the ordering and billing process was not efficient.

Prior Audit. Inspector General, DoD, Report No. 98-144 stated that DLA was in the process of issuing a solicitation for office products that duplicated GSA, National Industries for the Blind, and other DLA procurement and supply programs. DLA agreed to cancel the solicitation, and stated that it planned a review to determine the appropriate items for the DLA mission that should be included in a future solicitation.

As a result of its review, DLA issued a blanket purchase agreement on October 21, 1998, against a GSA Federal supply schedule, "Office Supplies - Next Day Delivery," for a vendor to supply office supplies. A blanket purchase agreement enables customers to negotiate discounts in addition to those obtained in the supply schedule. Customers using the blanket purchase agreement would be charged the DLA CRR of 4.8 percent and the GSA CRR of 1 percent. As of January 1999, there was one sale for approximately $7,800.

Services DLA Provided. Services that DLA provided after establishing initial prices for commodities added questionable value. DLA negotiated discounts in each of the 14 commodity groups included in the blanket purchase agreement. Considering the CRRs DLA and GSA charged, in 10 of the groups DLA negotiated a price that was less than the GSA price (0.2 percent to 9.2 percent). In the remaining four groups, the price was more than the GSA price (0.8 percent to 4.8 percent). We commend DLA for negotiating price discounts; however, its involvement in the ordering and billing process was less efficient.

Retail organizations that use the blanket purchase agreement to send orders directly to the vendor have the option of paying for materiel either with a credit card or through the interfund billing process. We compared the credit card process for materiel ordered through the blanket purchase agreement to the credit card process for orders placed through GSA Federal supply schedule contracts and found that DLA involvement in aspects of the process added questionable value. For orders placed through Federal supply schedule contracts, the GSA involvement was only to receive a rebate from the vendor to recoup its CRR. However, in the office supplies initiative, the Defense Industrial Supply Center received vendor order information, forwarded the order information to a credit card company to charge the customers account, established an active contract file to create an obligation, and forwarded the obligation data to the Defense Finance Accounting Service. Although the initiative made use of commercial credit cards as envisioned in the Defense Reform Initiative, the DLA involvement did not streamline the process.

Inspector General, DoD, Audit Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998, noted that there was a significant difference (from 7.6 percent to 18 percent) between DLA DVD CRRs charged by DLA supply centers and the GSA Federal supply schedule contracts (1 percent). DLA responded that the two agencies had completely different funding streams and customer service, and there must be an analysis and offsets to compensate for those differences. DLA further stated that it always had separate CRRs for each supply center, which were consistent with activity based costing. The goal for DLA was that each item provided by supply centers carry a price equal to the cost of the item.

According to GSA budget documents, the GSA supply schedule program was fully funded by its 1 percent CRR. Except for the payment process, the office supplies initiative used the same process. By using the office supplies initiative, DLA should have an opportunity to compare the differences to identify costs and processes that do not add value.

Customer Billings and Vendor Payments

The system DLA used to bill customers and pay vendors for materiel ordered through the E-CAT needed improvement. Specifically, controls were not in place to ensure that customer billings and vendor payments for materiel ordered through the E-CAT were made promptly. Our evaluation of E-CAT orders at the Naval Aviation Depot showed that the Naval Aviation Depot was not billed for all materiel received and a vendor was not paid for all materiel shipped. In a judgment sample[2] of six orders valued at $22,834, $9,773 was not billed to the depot and $10,750 was not paid to the vendor. For example, on February 4, 1998, the Depot ordered 48 hand tapered bits. The value of the order was $4,470. The materiel was posted as received in the depot on February 17, 1998. As of January 5, 1999, 11 months after receipt of the materiel, the depot still had not been billed and the vendor not paid.

Additionally, personnel at Walter Reed Army Hospital advised us that they had not been billed for materiel, valued at $1,470, that was received on April 7, 1998. We could not determine why the customers were not billed and the vendor not paid. We discussed the problem with DLA and the Defense Finance and Accounting Service personnel and they were researching the problem.

Summary

DLA implemented the E-CAT and office supplies initiatives to reduce inventories and increase the use of commercial distribution systems. As the customers in the E-CAT pilot program informed us, the management decision to not use the E-CAT was directly related to the high CRR associated with the purchases. One customer, however, used E-CAT because it was the approved source of supply. The Defense Federal Acquisition Regulation Supplement permits retail organizations to bypass the centralized supply systems when purchases are in the best interest of the Government in terms of cost, quality, and timeliness. Customers can go to the same vendors and purchase items without paying the CRR. Although it was too early to determine how much the office supplies initiative would be used, we believe that DLA was moving in the right direction by negotiating vendor discounts. If DLA can negotiate vendor discounts for products on the DoD Electronic Mall that exceed the CRRs, customers should be more willing to use the DoD Electronic Mall to make the purchases. Before this process can begin, DLA needs to determine its actual CRR and improve its customer billings and vendor payments process.

DLA needed to operate both initiatives as businesses to ensure that revenue generated from the assessment of CRRs recovered the full cost to execute the initiatives. For the E-CAT, DLA needed to ensure those customer billings and vendor payments were made promptly. Additionally, DLA needed to assess the effectiveness and efficiencies of costs incurred for the initiatives to make informed management decisions related to controlling costs and streamlining the process.

[2] Judgment sample does not generalize to the universe of all orders.

Management Comments on the Finding and Audit Response

A summary of DLA comments on the finding and our response are in Appendix D.

Recommendations, Management Comments, and Audit Response

1. We recommend that the Deputy Under Secretary of Defense (Logistics) issue a memorandum to the Services to reemphasize that the Defense Reform Initiative and Defense Federal Acquisition Regulation Supplement 208.7003-1 provide retail organizations the authority and flexibility to buy goods directly from vendors instead of processing requests through Government procurement offices, when the vendors offer the best value in cost, quality, and timeliness.

Management Comments. The Office of the Deputy Under Secretary of Defense (Logistics) concurred. It issued a memorandum to the Military Departments reminding them that they have substantial authority and flexibility to purchase centrally managed items from other sources, when those sources offer best value. The memorandum also stated that local purchase authority provides an important tool to retail organizations that can be used to meet the Secretary of Defense commitment to expand the degree to which buying decisions are made by the people who need the products.

2. We recommend that the Director, Defense Logistics Agency:

a. Develop a system to accumulate costs to properly establish a cost recovery rate for the electronic catalog program.

Management Comments. DLA partially concurred, stating that DLA tracked costs. DLA stated that the more critical issue was projecting sales accurately. Therefore, DLA tasked a vendor to work on projecting sales data required to establish an accurate CRR. Additionally, DLA plans to reduce the Electronic Mall CRR for current catalogs to 3 percent for DVD items.

Audit Response. The DLA comments were partially responsive. DLA did not identify the system for accumulating cost data for developing and administering the E-CAT that needed to be used in the CRR. Although sales are important to developing the CRR, cost is also an important element that is needed in developing the CRR. We request that DLA provide additional comments to describe the system used to identify and accumulate costs in response to the final report.

b. Establish procedures to ensure that costs for the electronic catalog are not included in both the electronic catalog cost recovery rate and other Defense Logistics Agency cost recovery rates, and that all costs are included in cost recovery rates for specific programs so that there is a basis to evaluate the effectiveness of the program and measure the program against established goals.

Management Comments. DLA nonconcurred, stating that there was no additional CRR rate placed upon items that already had a CRR established.

Audit Response. The DLA comments were not responsive. Its statement that no additional CRR was placed upon items with a CRR already established implies a misunderstanding of the finding. DLA charged its customers a 7 percent CRR for materiel ordered through the E-CAT. DLA did not have a system to identify a pool of costs that applied exclusively to the E-CAT, nor did it provide evidence that costs associated with E-CAT development and administration were excluded from the total administration costs used to calculate CRRs for other DLA programs. Consequently, customers using E-CAT were charged the 7 percent CRR; and customers using other DLA programs were also charged for the E-CAT because costs were not excluded from the CRR for other products. As a result, DLA was recovering its costs for E-CAT twice. We request that DLA reconsider its position and provide additional comments in response to the final report.

c. Identify the cost drivers for the office supplies initiative to determine the value added for those drivers, particularly costs associated with processing requisitions and payments through the Defense Industrial Supply Center and the Defense Finance and Accounting Service. The General Services Administration 1 percent recovery rate should be used as a benchmark.

Management Comments. DLA nonconcurred, stating that the GSA CRR alone is not an adequate benchmark and that the audit report does not take into account customer costs in using GSA schedules.

Audit Response. The DLA comments were not responsive. Benchmarking identifies analogs to selected processes for comparisons that can be made to determine whether the processes can be performed more efficiently and effectively. We recommended that DLA use the GSA CRR as a benchmark because of the significant difference in the CRRs charged by DLA (4.8 percent) and GSA (1 percent) and that DLA used the GSA Federal supply schedule in the initiative. We agree that in determining true added value, customer costs should be considered when providing any type of service. However, DLA provided us with no analysis to quantify the value added of the office supplies initiative or to show that customer costs were significantly different between the DLA and GSA alternatives. Whether ordering materiel through either the office supplies initiative or a GSA Federal supply schedule, customers will incur similar costs in determining best value; placing orders; when applicable, using credit cards; and following up on orders. As a result, we continue to believe that the GSA

CRR provides the most reasonable benchmark for evaluating the CRR for the office supplies initiative. Therefore, we request that DLA reconsider its position and provide additional comments in response to the final report.

d. Establish controls to ensure that customers are billed and vendors are paid promptly for materiel ordered through the electronic catalog. Additionally, after determining the cause for the lack of customer billing and vendor payment, determine whether any other programs are affected.

Management Comments. DLA partially concurred, stating that the billing and payment problem was a vendor invoicing problem that has been corrected. DLA also stated that it will work with the Defense Finance and Accounting Service to correct or prevent other contractor invoicing problems.

Audit Response. Although DLA only concurred partially, we consider the comments responsive.

Appendix A. Audit Process

Scope and Methodology

We evaluated procurement data provided by four retail organizations to determine whether the organizations procured brand name commercial items through the most economic and efficient centralized Federal procurement program. Specifically, we selected a judgment sample of 365 items that had significant demands (dollar value of requirements) and were submitted through the centralized supply system. Also, we reviewed the process that DLA used to compute the CRRs for the E-CAT and office supplies commercial inventory initiatives. We determined whether costs and sales data were properly used in computing the CRRs, and whether a system was in place to identify actual costs incurred for administering the programs. We contacted or visited the four customers included in the E-CAT pilot program, along with the Fleet Industrial Supply Center, San Diego, and the Naval Aviation Depot, North Island, to determine the reasons for the use or nonuse of the electronic catalog. We selected a judgment sample of E-CAT orders to evaluate billings to the Naval Aviation Depot and Walter Reed Army Hospital and vendor payments for the materiel ordered. To determine whether the Naval Aviation Depot and the Walter Reed Army Hospital were billed properly and the vendor paid for the E-CAT orders, we reviewed depot and hospital billing records and Defense Finance and Accounting Service and Defense Supply Center financial records. The documentation we reviewed covered the period from April 1997 through January 1999.

DoD-wide Corporate Level Goals. In response to the Government Performance Results Act, DoD has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objective and goal.

> **Objective:** Fundamentally reengineer DoD and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. **(DoD-6)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Acquisition Functional Area. Objective:** Deliver great service. **Goal:** Simplify purchasing and payment by using purchase card transactions for 90 percent of all DoD micropurchases while reengineering requisitioning, funding, and ordering. **(ACQ-1.3)**

- **Acquisition Functional Area. Objective:** Foster partnerships. **Goal:** Decrease paper transactions by 50 percent through electronic commerce and electronic data exchange. **(ACQ-2.3)**

- **Logistics Functional Area. Objective:** Streamline logistics infrastructure. **Goal:** Implement most successful business practices (resulting in reductions of minimally required inventory levels). **(LOG-3.1)**

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

Use of Computer-Processed Data. We used computer-processed E-CAT procurement data provided by DLA. To the extent that we reviewed the computer-processed data, we concluded that the data were sufficiently reliable to be used in meeting our objectives. We did not audit the system that produced the data.

Audit Type, Dates, and Standards. We performed this economy and efficiency audit from June 1998 through January 1999 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD. Further details are available on request.

Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provide reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of the DLA management controls over developing CRRs, and in billing customers and paying vendors for orders placed through E-CAT. We also reviewed management's self-evaluation of those controls.

Adequacy of Management Controls. We identified a material management weakness for the DLA as defined by DoD Directive 5010.38. DLA management controls were not adequate to ensure that customers were properly billed and vendors promptly paid for orders placed through E-CAT. With the expansion of the E-CAT and electronic mall initiative, the deficiency was considered material. Recommendations in this report, if implemented, will correct the material weakness. We could not determine the amount of the monetary benefits because it is dependent on future review results and associated management decisions. While management controls over developing CRRs needed improvement, the deficiency was not considered material. A copy of the report will be provided to the senior official responsible for management controls in DLA.

Adequacy of Management's Self-Evaluation. DLA did not identify E-CAT customer billings and vendor payments as an assessable unit and, therefore, did not identify or report the management control weakness identified by the audit.

Appendix B. Summary of Prior Coverage

During the last 5 years, the Inspector General, DoD, issued the following related reports.

Inspector General, DoD, Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998.

Inspector General, DoD, Report No. 98-144, "Dual Management of Commercially Available Items - Information and Imaging Solutions," June 3, 1998.

Inspector General, DoD, Report No. 98-088, "Sole Source Prices for Commercial Catalog and NonCommercial Spare Parts," March 11, 1998.

Inspector General, DoD, Report No. 97-205, "Dual Management of Commercially Available Items - Defense Logistics Agency Electronic Catalog Pilot Program," August 15, 1997.

Appendix C. Purchasing Practices for High Demand Items

Evaluation of High Demand Procurements. Our evaluation of procurement data provided by four retail organizations (Defense Distribution Depot Susquehanna, New Cumberland, Pennsylvania; Fleet Industrial Supply Center, Norfolk, Virginia; Fort Bragg, Fayetteville, North Carolina; and McGuire Air Force Base, Wrightstown, New Jersey) showed that, with minor exceptions, the organizations generally procured brand name commercial items through the most economic and efficient centralized Federal procurement program.

We selected a judgment sample of 365 items that had significant demands (dollar value of requirements) and were submitted through the centralized supply system. The 365 items were the types of items included in Federal supply classes managed by both DLA and GSA. The annual demand value for the 365 items was approximately $11.3 million. Our evaluation of the 365 items showed that only 30 of the 365 items were available from both DLA and GSA. The items included batteries, film, food service equipment, and copier toner. Our analysis of DLA and GSA pricing data showed that for 17 of the 30 items procured through DLA, the organizations could have obtained the items from GSA at a lower price. However, using DLA annual demand data for all requirements, we estimated that the savings would have been about $200,000 if all materiel was ordered from GSA. Our evaluation did not consider other factors such as delivery terms and customer preference. We provided each of the organizations a list of the items in which GSA had lower pricing. Our analysis also showed that DLA provided lower pricing for the other 13 items that were available from both DLA and GSA.

Appendix D. Defense Logistics Agency Comments on the Finding and Audit Response

The following is a summary of DLA comments on the draft report finding and the audit response to those comments.

E-CAT Inclusion in Electronic Mall. Page 1, paragraph 4, line 6. DLA stated that our statement, "In January 1998, the catalog was incorporated into the DoD electronic mall," was incorrect because incorporation of the E-CAT is underway and almost complete.

Audit Response. The Director, DLA, in response to the National Defense Act for Fiscal Year 1998, provided a report to Congress stating that the latest phase of the electronic mall, fielded January 1998, provided customers access to individual DLA (E-CAT) and non-DLA stores. We understand that although E-CAT was incorporated in January 1998, additional E-CAT vendors are being added to the electronic mall.

Use of the Office Supplies Initiative. Page 2, paragraph 1, line 1. DLA stated that we misstated that the DLA blanket purchase agreement is for DLA use. According to DLA, the blanket purchase agreement will be presented to customers throughout DoD and to base supply stores that the National Industries for the Blind operated.

Audit Response. The audit report stated that the initiative was "to provide office supplies to DLA customers." In that context, DLA customers include DLA organizations, the Military Departments, and other Government organizations.

Estimated Sales for Office Supplies Initiative. Page 2, paragraph 1, line 13. DLA stated that the projected FY 1999 sales of $2.9 million for the office supplies initiative seems to be based on one-half of the long-term yearly projected sales of $5.8 million. DLA advised us that the $5.8 million was not accurate for the initial setup period, which carried an estimate of $4 million.

Audit Response. We based our estimate of $2.9 million of sales for FY 1999 on the $4 million of estimated sales specified in the office supplies blanket purchase agreement. The blanket purchase agreement estimated, but did not guarantee, the vendor $4 million of sales from October 21, 1998, through January 31, 2000. In determining the $2.9 million for FY 1999, we simply calculated the daily rate and prorated the $4 million in estimated sales over the period of October 21, 1998, through September 30, 1999.

E-CAT CRR. Page 5, paragraph 5, line 1. DLA stated that to set an accurate CRR both cost and sales figures are needed. However, because there was no good model for predicting sales, DLA chose to use the lowest DVD rate until it had more experience with the system. DLA believed the rate was fair because the 7.6 percent CRR was the lowest CRR it charged any of its other customers. DLA also stated that we did not consider the fact that DLA is incurring a

2.125 percent charge on credit card sales. DLA has tasked a contractor to develop the best possible CRR for the future. That contractor is developing an appropriate model.

Audit Response. DLA did not have a system to identify and accumulate costs and did not use an estimate of cost or sales in establishing the CRR for the E-CAT. We agree it is difficult to estimate cost and sales for computing an appropriate CRR. However, in March 1996, approximately 1 year before the start of the E-CAT pilot program, a vendor that DLA contracted to conduct a preliminary functional economic analysis of the E-CAT provided DLA estimates of E-CAT costs and sales. Although information was initially provided, those estimated costs and sales were not used in establishing the CRR for E-CAT. If DLA is incurring a 2.125 percent charge on credit card sales, we agree that those charges should be considered in establishing the CRR for the future. DLA is taking responsive action in tasking a contractor to develop an appropriate model for determining the CRR.

E-CAT Costs and Customer Overcharging. Page 6, paragraph 2. DLA stated that the draft report statement that it did not have a system to identify and collect E-CAT costs and that it did not exclude E-CAT costs from those used to calculate CRRs for other programs seemed contradictory. DLA also stated that the E-CAT program manager and DLA Headquarters personnel did track E-CAT development costs; however, much of the development expense was funded with research and development funds that were not expected to be recovered.

Audit Response. DLA did not have a system to identify and collect E-CAT costs and DLA personnel were unable to provide us neither the estimated costs to develop the CRR nor actual costs incurred for the program. We agree that research and development funds were used to develop E-CAT and those costs should not be used in calculating the CRR. However, costs other than research and development (for example, operations and maintenance funds for DLA headquarters and Defense Supply Center Richmond operations) must have been incurred to justify a CRR for E-CAT. In the absence of a system to identify those costs, DLA was unable to isolate costs associated with the E-CAT and exclude those specific E-CAT costs from CRRs for other programs. As a result, costs for E-CAT were recovered from customers twice, once in the E-CAT CRR and once in the CRR of the other programs.

E-CAT Value. Page 6, paragraph 3, line 1. DLA stated that the draft report questioned the value of E-CAT and compared the E-CAT CRR to the 1 percent used by GSA. It also stated that the report failed to note the other advantages of E-CAT, such as one-stop shopping for a wide range of items.

Audit Response. Our report stated that the value DLA added to aspects of the E-CAT procurement process was questionable. The report did not question the value of E-CAT. The report commended DLA for implementing commercial inventory initiatives such as the E-CAT. We agree that the E-CAT has many advantages; however, retail organizations must determine the source of supply that provides best value. We questioned the value that DLA added when retail organizations could have obtained products directly from an E-CAT vendor without paying the DLA CRR.

Offices Supplies Initiative CRR. Page 8, paragraph 3, line 6. DLA stated that the draft report did not fully explain figures that referred to estimated annual sales of $5.8 million in the CRR calculation instead of $3.2 million that was negotiated with the vendor selected to provide the supplies. It also stated that the $5.8 million was an end goal when the initiative was fully operational. The invitation to participate in the blanket purchase agreement used a $4 million estimate for the first year of business.

Audit Response. The $5.8 million may have been an end goal but we continue to believe that the $5.8 million was an inappropriate estimate for calculating the CRR for the office supplies initiative. The $4 million in the blanket purchase agreement was an estimate over about 15 months of business (October 21, 1998, through January 31, 2000), not 1 year. Based on a daily rate for the $4 million, we estimated that $3.2 million of sales would occur for 12 months of business. Our estimate of $2.9 million applies to about 11 1/3 months of business in FY 1999, beginning on October 21, 1998.

Office Supplies Initiative Discounts. Page 9, paragraph 1, line 7. DLA stated that although we commended DLA for negotiating price discounts, we did not completely explain the extent of the discounts regarding customer value. DLA further stated that the best discounts were negotiated for the most commonly ordered items.

Audit Response. The report commended DLA for the discounts negotiated. However, it is too early in the process to address the extent of customer value because the initiative has not generated significant sales. The measurement of the initiative's value will depend on the extent customers use the initiative.

Office Supplies Initiative Credit Card Orders. Page 9, paragraph 2, line 3. DLA stated that the audit found questionable value in the billing process under the blanket purchasing agreement. DLA believed that we did not consider that the initiative allows the vendor to roll up billing under one account instead of many.

Audit Response. We agree that the vendor's ability to roll up billing under one account is beneficial to customers. The report raises the issue that DLA and the Defense Finance and Accounting Service have extensive involvement in processes of the office supplies initiative that GSA tends to minimize. Consequently, the DoD involvement complicates rather than streamlines the process and adds little, if any, value.

GSA CRR. Page 9, paragraph 4, line 1. DLA stated that while GSA may be fully funded by its 1 percent CRR, the draft report did not consider customer costs in using GSA schedules. Customer costs include determining best value from numerous schedules and contracts, placing orders, reconciling credit card bills, following up, and administering individual orders.

Audit Response. We did not evaluate customer costs. However, we believe the differences would be minimal between costs incurred for orders placed through either the office supplies initiative or GSA Federal supply schedule contracts and the GSA Advantage program. We discussed the significant difference in the CRRs between the office supplies initiative (4.8 percent) and

GSA (1 percent) and the appropriateness of DLA involvement in aspects of the initiative. We continue to believe that the GSA CRR provides the best available benchmark for DLA to identify cost drivers in the initiative and to determine the value added for those drivers.

E-CAT Customer Billings and Vendor Payments. Page 9, paragraph 5, line 2. DLA stated that the problem identified in the draft report that related to customer billings and vendor payments occurred because a vendor was not invoicing properly. The vendor has since corrected the problem.

Audit Response. Actions that DLA has taken to correct the billing and payment problem are responsive.

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
  Deputy Under Secretary of Defense (Logistics)
  Assistant Deputy Under Secretary of Defense (Materiel and Distribution Management)
  Director, Defense Logistics Studies Information Exchange
  Director, Defense Reform Office
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program and Budget)
Assistant Secretary of Defense (Public Affairs)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Deputy Chief of Staff (Logistics)
  Commander, Army Materiel Command
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Commander, Naval Supply Systems Command
Commander, Fleet Industrial Support Center, San Diego
Commander, Naval Aviation Depot, North Island
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Deputy Chief of Staff (Installations and Logistics)
Commander, Air Force Materiel Command
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Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
  Commander, Defense Supply Center Richmond
  Commander, Defense Industrial Supply Center
Director, National Security Agency
  Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
National Security and International Affairs Division
Technical Information Center
Inspector General, General Services Administration

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 Management, Information, and Technology, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform

Office of the Deputy Under Secretary of Defense (Logistics) Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

ACQUISITION AND TECHNOLOGY

MAY 11

(L/MDM)

MEMORANDUM FOR DOD INSPECTOR GENERAL

THROUGH: CHIEF, CAIR CS Navarro 5-6-99

SUBJECT: Draft Audit Report, "Financial Impacts of Defense Logistics Agency Electronic Catalog and Office Supplies Initiatives on Retail level Purchasing," Dated March 19, 1999 (Project No. 8LD-0040)

This responds to your memorandum of March 19, 1999, on the subject draft audit report. One recommendation was addressed to this office:

"1. We recommend that the Deputy Under Secretary of Defense (Logistics) issue a memorandum to the Services to reemphasize that the Defense Reform Initiative and Defense Federal Acquisition Supplement 208.7003-1 provide retail organizations the authority and flexibility to buy goods directly from vendors instead of processing requests through Government procurement offices, when the vendors offer the best value in cost, quality, and timeliness."

This office concurs with the recommendation. Attached is a copy of the memorandum issued to the Military Departments reminding them of the substantial authority and flexibility established in DoD FAR Supplement (DFARS) 208 7003-1 to purchase centrally managed items from other sources, when those sources provide the best value.

for Roger W. Kallock
Deputy Under Secretary
of Defense (Logistics)

Attachment

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION AND TECHNOLOGY

(L/MDM)

MAY 11 1999

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (ACQUISITION, LOGISTICS, AND TECHNOLOGY)
ASSISTANT SECRETARY OF THE NAVY (RESEARCH, DEVELOPMENT, AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE (ACQUISITION)

SUBJECT: Authority to Purchase Items Assigned for Integrated Materiel Management From Other Sources

Recent findings by the Department of Defense (DoD) Office of Inspector General indicate that DoD activities should be reminded that they have substantial authority to purchase items assigned for integrated materiel management items from other sources. The DoD Federal Acquisition Regulation Supplement (DFARS) grants authority for local purchase of items assigned for Integrated Materiel Management under cirucumstances of unusual and compelling urgency, or when a supply system code for local purchase is assigned or the Integrated Materiel Manager otherwise grants authority to purchase locally.

In addition, DFARS 208.7003-1 grants local purchase authority to obtain items from sources other than the Integrated Materiel Manager when such action "…is in the best interest of the Government in terms of the combination of quality, timeliness, and cost that best meets the requirement." Please note that this provision does not apply to items: (a) critical to the safe operation of a weapon system; (b) with special security characteristics; or (c) that are dangerous. In addition, if purchases made under this provision exceed the micro-purchase threshold in FAR Part 13, the contract file must be documented with a statement of the specific advantage of local purchase. Finally, a waiver must be obtained from the Integrated Materiel Manager prior to the initiation of an acquisition exceeding the simplified acquisition threshold in FAR Part 13.

The local purchase authority discussed above provides an important tool to DoD activities that can be used to help meet Secretary of Defense Cohen's commitment in the Defense Reform Initiative Report to expand the degree to which buying decisions are made by the people who need the products. I request that you forward this reminder to your field activities

for Allen W. Beckett

Roger W. Kallock
Deputy Under Secretary
of Defense (Logistics)

cc:
Deputy Chief of Staff (Logistics), USA
Deputy Chief of Naval Operations (Logistics)
Deputy Chief of Staff (Installations & Logistics), USAF
Deputy Chief of Staff for Installations & Logistics, HQ USMC

Defense Logistics Agency Comments

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

IN REPLY REFER TO

DDAI May 21, 1999

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING DEPARTMENT OF DEFENSE

SUBJECT: Financial Impacts of DLA Electronic Catalog and Office Supplies Initiatives on Retail Level Purchasing, Project No. 8LD-0040

This is in response to your March 19, 1999 request for comments on the above DoD-IG draft audit report. If you have any questions, please contact Ms. Annell W. Williams, 703-767-6274.

Encl

JEFFREY GOLDSTEIN
Chief, Internal Review Office

Final Report
Refererence

MAY 20 1999

SUBJECT: DoD IG Draft Audit: Financial Impacts of DLA Electronic Catalog and Office Supplies Initiatives on Retail Level Purchasing (Project No. 8LD-0040)

Audit Comment: Page 1, paragraph 4, DLA Electronic Catalog, line 4 states, "In January 1998, the catalog was incorporated into the DoD electronic mall." Page 1, paragraph 4, line 6

DLA Response: This is incorrect since incorporation of E-CAT is currently underway and almost complete.

Audit Comment: Page 2, first paragraph, DLA Office Products Initiative, line 1 states, "On October 21, 1998, DLA established a blanket purchase agreement with a vendor in the General Services Administration (GSA) Federal supply schedule to provide office supplies to DLA customers." Page 2, paragraph 1, line 1

DLA Response: The IG states the DLA blanket purchase agreements are for DLA use. While some, if not all, DLA activities may be expected to use the BPA, it will also be presented to potential customers throughout DoD and to National Industries for the Blind operated base supply stores.

Audit Comment: Page 2, first paragraph, DLA Office Products Initiative, line 11 states, "FY 1999 sales for office supplies are projected to be $2.9 million." Page 2, paragraph 1, line 13

DLA Response: While the IG audit states the projected sales are $2.9 million, no one supplied the IG with such a figure, which seems to be based on one half of the long term yearly projected sales. The auditors had been advised this yearly amount of $5.8 million was not accurate for the initial set up period, which carried an estimate of $4 million total.

Audit Comment: Page 6, paragraph 1, Process Used to Develop CRR, line 1, states, "The DLA process used to develop the Cost Recovery Rate (CRR) for E-CAT was flawed." Page 5, paragraph 5, line 1

DLA Response: The IG is correct in saying that to set an accurate CRR both *cost* and *sales* figures are needed. However, the key is projecting sales for a new internet based tool like ECAT/EMall. At the time there was no good model for predicting such sales and without a good sales estimate no CRR could have been relied on. Therefore, we chose to use the lowest direct vendor delivery (DVD) rate in use (7.6%) until we had more experience with the system. We believe that was a reasonable approach. Since sales are relatively low to date, the CRR collected is minimal. Moreover, we think it is difficult to say customers were overcharged when the rate applied was as low as any other rate the Agency charges. The IG also did not consider the fact that for now we are incurring a 2.125% charge on credit card sales. We have tasked a contractor to help develop the best possible CRR in the future, and they are working on development of an appropriate model, but that still will require assumptions on sales.

Final Report
Reference

Final Report Reference	
Page 6, paragraph 2	**Audit Comment:** Page 6, paragraph 2, Process Used to Develop CRR, the report indicates DLA could not identify E-CAT costs, that customers were overcharged because of the CRR, and that DLA recouped E-CAT costs twice. **DLA Response:** The report states DLA did not have a system to identify and collect costs associated with E-CAT. In this same paragraph it states DLA did not exclude E-CAT costs from those used to calculate CRRs for other programs. These statements seem contradictory. The E-CAT Program Manager and DLA Headquarters personnel did track E-CAT development costs; however, much of that expense was Research & Development (R&D) money where direct payback was not expected. We have been unable to document that E-CAT development costs were included in Inventory Control Point (ICP) CRR calculations. The method used by DLA to determine a CRR for E-CAT, in the absence of actual data, was a good business decision considering this project was at its beginning stage. Using the lowest possible DVD CRR available at the time was reasonable. We plan to pursue a variable cost recovery rate capability which would be dictated by the item(s) being ordered.
Page 6, paragraph 3, line 1	**Audit Comment:** Page 6, paragraph 3, Value Added, line 1 states "The value that DLA added to aspects of the E-CAT procurement process was questionable." **DLA Response:** The report questions the value of E-CAT and seemed to compare its CRR (in verbal discussions) to the 1% used in GSA Advantage. The report fails to note the other advantages of E-CAT: one stop shopping for a wide range of items (especially when it is combined with EMALL), rapid deliveries, ease of use, a single registration and ordering method, and a full range of contract administration services support.
Page 8, paragraph 3, line 6	**Audit Comment:** Page 8, paragraph 6, Process Used to Develop CRR, line 5 states "Additionally, DLA used estimated annual sales of $5.8 million in the CRR calculation instead of the $3.2 million that was negotiated with the vendor selected to provide the supplies." **DLA Response:** The figures used in this paragraph are not fully explained. The figure of $5.8 million was an end goal once the BPA was fully operational. The invitation to participate in a BPA used a $4 million estimate for the first year of business.
Page 9, paragraph 1, line 7	**Audit Comment:** Page 9, paragraph 3, Services DLA Provided, line 6 states, "We commend DLA for negotiating price discounts, however, its involvement in the ordering and billing process was less efficient." **DLA Response:** We disagree. This paragraph does not completely explain the extent of the discounts in terms of customer value since the best discounts were negotiated for the most commonly ordered items and the discounts that would not produce prices below the GSA price were on items that would not be expected to be ordered on a regular basis, i.e., typewriter ribbons. The value the Defense Industrial Supply Center (DISC) adds is where patterns of increased usage are identified, better prices can be periodically negotiated.
Page 9, Paragraph 2, Line 3	**Audit Comment:** Page 9, paragraph 4, Services DLA Provided, line 3 states, "We compared the

Final Report
Reference

credit card process for material ordered through the BPA to the credit card process for orders placed through GSA Federal supply schedule contracts and found that DLA involvement in aspects of the process added questionable value."

DLA Response: The audit sees the billing process under the BPA of questionable value. It does not consider the BPA allows the vendor to roll up billing under one account instead of many. Processes such as this lead to the discounts customers enjoy under the BPA.

Audit Comment: Page 10, paragraph 2, line 1 states, "According to GSA budget documents, the GSA supply schedule program was fully funded by its 1 percent CRR."

Page 9, paragraph 4, line 1

DLA Response: While GSA may be fully funded by the 1 percent CRR (although this has not been fully demonstrated), the report does not take into account customer costs in using the GSA schedule which include determining best value from numerous schedules and schedule contracts, in placing orders, in credit card reconciliation costs, and in following up and administering individual orders.

Audit Comment: Page 10, paragraph 3, line 2 states, "Specifically, the controls were not in place to ensure that customer billings and vendor payments for material ordered through the E-CAT were made promptly."

Page 9, paragraph 5, line 2

DLA Response: Our examination of this problem found that W.W. Grainger was not invoicing properly—they were submitting only one copy vice the required three. Because shipping data in most cases is entered when a proper invoice is processed, Grainger was not getting paid, nor was the customer being billed. Grainger has since corrected this problem after consultation with DFAS Columbus.

Audit Report Recommendations

Recommendation 2.a.: "Develop a system to accumulate costs to properly establish a cost recovery rate for the electronic catalog program."

DLA Response: Partially concur. We track EMall/ECAT costs. The more critical issue is projecting sales with some degree of accuracy. DLA has tasked KPMG Peat Marwick to work on this. In addition, the DLSC Commander has approved a reduction of the EMALL CRR for current catalogs to 3% for DVD items.

Recommendation 2.b.: "Establish procedures to ensure costs for the electronic catalog are not included in both the electronic catalog cost recovery rate and other Defense Logistics Agency cost recovery rates, and that all costs are included in cost recovery rates for specific programs so that there is a basis to evaluate the effectiveness of the program and measure the program against established goals."

DLA Response: Non-concur. There was no *additional* cost recovery rate placed upon items that already had a cost recovery rate established. The E-CAT cost recovery rate (and now the EMall CRR) are applied only to EMall DVD catalog items.

Recommendation 2.c.: "Identify the cost drivers for the office supplies initiative to determine the value added for those drivers, particularly costs associated with processing requisitions and payments through the Defense Industrial Supply Center and the Defense Finance and Accounting Service. The General Services Administration 1 percent recovery rate should be used as a benchmark."

DLA Response: Non-concur. The GSA recovery rate alone is not an adequate benchmark. While GSA Advantage may be fully funded at one percent (although this has not been fully demonstrated) the report does not take into account customer costs in using the GSA schedule including determining best value from numerous schedules and schedule contracts, in placing orders, in credit card costs, and in follow-up and administration of individual orders.

Recommendation 2.d.: "Establish controls to ensure that customers are billed and vendors are paid promptly for material ordered through the electronic catalog. Additionally, after determining the cause for the lack of customer billing and vendor payment, determine whether any other programs are affected."

DLA Response: Partially concur. As described above, the billing and payment problem the IG cited was a vendor invoicing problem which has been corrected. We will remain vigilant and work with DFAS to correct/prevent other contractor invoicing problems. Incorrect invoicing will negatively effect any program.

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