

Audit



Report

CONTRACT TERMINATIONS AT DEFENSE INDUSTRIAL SUPPLY
CENTER AND DEFENSE SUPPLY CENTER PHILADELPHIA

Report Number 99-024

October 29, 1998

Office of the Inspector General
Department of Defense

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Acronyms

CIT	Consumable Item Transfer
DLA	Defense Logistics Agency
DISC	Defense Industrial Supply Center
DSCP	Defense Supply Center Philadelphia
GAO	General Accounting Office
ICP	Inventory Control Point
NSN	National Stock Number
SAMMS	Standard Automated Materiel Management System



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October 29, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Contract Terminations at Defense Industrial Supply Center and Defense Supply Center Philadelphia
(Report No. 99-024)

We are providing this report for your information and use. This is the second report on the Defense Logistics Agency process of identifying, reviewing, and terminating excess procurements. We considered management comments on a draft of this report in preparing the final report.

Comments conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Tilghman A. Schraden at (703) 604-9186 (DSN 664-9186) or Ms. Kathryn L. Palmer at (703) 604-8840 (DSN 664-8840). See Appendix E for the report distribution. The audit team members are listed inside the back cover.

A handwritten signature in cursive script that reads "David K. Steensma".

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 99-024

(Project No 7LD-3011.01)

October 29, 1998

Contract Terminations at Defense Industrial Supply Center and Defense Supply Center Philadelphia

Executive Summary

Introduction. This is the second and final report in a series on contract terminations. This report focuses on the Defense Industrial Supply Center and the Clothing and Textile Directorate at the Defense Supply Center Philadelphia. The first report focused on the Defense Supply Center Columbus and the Defense Supply Center Richmond. In testimony before Congress, the General Accounting Office stated that nearly \$34 billion, about half of the DoD inventory of secondary items, was not needed to support war reserve or current operating requirements. As part of its National Performance Review Reinvention Impact Center, DoD set a goal of reducing DoD inventory by \$12 billion by the year 2000. DoD incorporated the goal into its Government Performance and Results Act plan.

DoD inventory control points, which manage spare and repair parts, procure supply items, and award contracts, initiate contract terminations to avoid the purchase of unneeded inventory. The Defense Logistics Agency (DLA) inventory control points are located at four supply centers. During FY 1997, the DLA supply centers managed about 4 million items and had gross sales of about \$7 billion. Included in these totals for the same period, the Defense Industrial Supply Center managed approximately 1 million national stock numbers (NSNs) with gross sales of \$848 million. The Clothing and Textile Directorate at the Defense Supply Center Philadelphia managed approximately 31,000 NSNs and had sales of about \$1 billion in FY 1997.

Audit Objectives. The overall audit objective was to determine whether the DLA wholesale inventory control points terminated the procurement of excess quantities of materiel in response to reduced inventory requirements. The specific objective of this report was to evaluate the contract termination process at the Defense Industrial Supply Center and the Clothing and Textile Directorate at the Defense Supply Center Philadelphia. The management control program as it applied to the audit objectives was reviewed in Inspector General, DoD, Report No. 98-172, "Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond," July 2, 1998.

Audit Results. The Clothing and Textile Directorate at the Defense Supply Center Philadelphia was effectively managing commodities to avoid excess procurements. However, the Navy, the Air Force, and the Defense Industrial Supply Center procedures for managing terminations of contracts and purchase requests for materiel potentially in excess to requirements needed improvement. Of 103 NSNs judgmentally sampled, valued at \$21.3 million, 69 NSNs had no evidence of prompt reviews by item managers at the Defense Industrial Supply Center. Additionally, at the Defense Industrial Supply Center, 68 NSNs out of the 103 sampled items were incorrectly reported as potentially excess procurements. The Defense Industrial Supply Center had

initiated procurements valued at \$2.4 million for materiel in excess to requirements that were canceled as a result of the audit for a net savings of \$1.9 million. The Defense Industrial Supply Center procured another \$2.2 million in excess materiel that was received in inventory, was being shipped, or was no longer economical to cancel. The purchase of excess materiel resulted in lost opportunities to reduce the DoD inventory as well as lost opportunities to put funds to better use.

As a result of Inspector General, DoD, Report No. 93-146, "Contract Terminations at DoD Wholesale Inventory Control Activities," June 30, 1993, DLA had reported untimely contract terminations as a material management control weakness in each subsequent DLA annual statement of assurance. Our first report in this series, Inspector General, DoD, Report No. 98-172, "Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond," July 2, 1998, stated that DLA had not yet completed corrective action on the material management control weakness. See Appendix A for a discussion of the management control program.

Implementing the recommendations should contribute to reducing DoD supply inventories consistent with the DoD goals. See Part I for a discussion of the audit results.

Summary of Recommendations. We recommend that the Defense Logistics Agency develop procedures and controls to ensure that the Standard Automated Materiel Management System database is updated, verified, and accurately maintained to reflect the most current information. We recommend that the Defense Logistics Agency focus management attention on contract terminations by establishing contract reduction coordinator positions at its inventory control points as required by DoD Regulation 4140.1-R, "DoD Materiel Management Regulation," January 25, 1993.

Management Comments. The Defense Logistics Agency concurred and stated that the Defense Logistics Support Command issued additional guidance to Defense Logistics Agency supply centers. The FY 1999 material control objective on overprocurement terminations will track implementation of the guidance. See Part I for a discussion of management comments and Part III for the complete text of management comments.

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Part I - Audit Results

Audit Background

Defense Inventory Management. In February 1997, the General Accounting Office (GAO) identified DoD inventory management as a high risk management problem in GAO/HR-97-1 "High Risk Series: An Overview," February 1, 1997. In its testimony before the House Subcommittee on National Security, International Affairs, and Criminal Justice, on "Defense Inventory Management: Problems, Progress, and Additional Actions Needed," March 20, 1997, the GAO maintained that about \$34 billion, or about half of the DoD \$69.6 billion inventory of spare parts and other secondary inventory items, was not needed to support war reserve or current operating requirements.

Consistent with the GAO testimony, DoD set goals of reducing inventory. In the 1996/1997 edition of the DoD Logistics Strategic Plan, DoD set inventory reduction as one of several goals aimed at streamlining the logistics infrastructure. The DoD Logistics Strategic Plan for 1996/1997 states that every logistics dollar expended on unneeded inventory is a dollar not available to build, modernize, or maintain warfighting capability.

Role of Inventory Control Points. The DoD supply system uses wholesale inventory control points (ICPs) to manage spare and repair parts and other consumable items. The Defense Logistics Agency (DLA) manages four ICPs: Defense Industrial Supply Center (DISC), Philadelphia, Pennsylvania; Defense Supply Center Columbus, Ohio; Defense Supply Center Philadelphia (DSCP), Pennsylvania; and Defense Supply Center Richmond, Virginia. ICPs procure supply items based on customer demand factors obtained from several sources. Those sources include records of reported inventory on hand and on order, historical demand, and customer forecasts of demand. Customer forecasts of demand include planned maintenance as well as changes to historical use. ICPs might award contracts for materiel in excess of requirements because of changes in demand. For example, when changes occur in authorizations or quantities of weapon systems being supported because of a change in a military mission, the need for on-hand and on-order materiel may change for those systems. Additionally, attrition, changes in demand, repair, and other factors that justified procurement of the items can cause ICPs to have excess materiel on order from contractors.

Consumable Item Transfer. In 1990, the Deputy Secretary of Defense approved the transfer of the management of consumable items from the Military Departments to DLA. As a result, the Military Departments and DLA developed a plan for a two-phased transfer. The first phase was completed in 1995, and the second phase is scheduled to be complete during 1998. The plan included business rules for consumable item transfers (CITs). Those rules specifically require that DLA not dispose of materiel transferred by the Military Departments until at least 2 years have passed from DLA assuming management of the item, unless the Military Department gives prior approval. The business rules precluding disposals do not prevent DLA from recommending that the Military Departments terminate excess procurements of CITs. In fact, the business rules require that DLA item managers ensure that all data, to include

item manager folders and program-driven requirements information, have been considered prior to requesting cancellation or termination of any purchase request as a result of a notice of potentially excess procurement.

Guidance on Contract Terminations. DoD policy on contract terminations is contained in DoD Regulation 4140.1-R, "DoD Materiel Management Regulation," January 25, 1993. The Regulation includes guidance on ICP procedures and responsibilities for item managers and contracting officers in determining and processing contract terminations. DLA issued additional guidance on business rules for CITs that affect contract terminations. The Federal Acquisition Regulation, subpart 49.101, "Authorities and Responsibilities," requires that contracting officers terminate unneeded materiel from contracts when it is in the Government's best interest. See Appendix C for a discussion of guidance on contract terminations.

Audit Objectives

The overall audit objective was to determine whether the DLA wholesale ICPs terminated the procurement of excess quantities of materiel in response to reduced inventory requirements. The specific objective of this report, the second in a series, was to evaluate the contract termination process at DISC and the Clothing and Textile Directorate at DSCP. The first report focused on the Defense Supply Center Columbus and Defense Supply Center Richmond. See Appendix A for a discussion of the audit scope and methodology, and the management control program as reviewed in Inspector General, DoD, Report No. 98-172, "Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond," July 2, 1998. See Appendix B for a list of prior coverage.

Managing Contract Terminations

The Navy, the Air Force, and the DISC procedures for managing terminations of contracts and purchase requests for materiel potentially in excess to requirements needed improvement. Of 103 national stock numbers (NSNs) judgmentally sampled, 69 NSNs had no evidence of prompt reviews by item managers at DISC. Additionally, at DISC, 68 NSNs out of the 103 sampled items were incorrectly reported as potentially excess procurements. The Navy and the Air Force also did not follow the joint business rules for managing the transition of CITs from the Service ICPs to DLA. The conditions occurred because DLA and DISC did not exercise sufficient management oversight for timely reviews of notices of potentially excess procurement and for database maintenance. In addition, Navy and Air Force ICPs did not provide sufficient oversight for the transition of CITs from the Service ICP to DLA. The purchase of excess materiel resulted in lost opportunities to reduce the DoD inventory as well as lost opportunities to put funds to better use.

Procedures for Managing Contract Terminations

The DISC procedures for managing terminations of contracts and purchase requests for materiel potentially in excess to requirements needed improvement. For the 2-month period, February and March 1998, DISC had notices of potentially excess procurement for 4,800 NSNs, valued at \$48.9 million. Of those 4,800 notices, DISC reported termination of 969 procurements valued at \$9.7 million. For our review, we judgmentally selected 103 NSNs, valued at \$21.3 million, from the February and March lists of notices of potentially excess procurements. For those 2 months, the 103 sample items accounted for about 44 percent of the total dollar value of the items identified as potentially excess procurements. The range of values reported in the notices of potentially excess procurement for the potential savings went from a high of \$2.5 million to a low of \$15,000. The methodology for selecting the sample is described in Appendix A.

From our sample of 103 NSNs, procurement actions for 68 NSNs, valued at \$15.6 million, were incorrectly reported as being potentially excess. Of the remaining 35 NSNs that were correctly reported as potentially excess, 9 excess procurements, valued at about \$765,100, were terminated by DISC. As a result of the audit, DISC terminated an additional eight procurements, valued at \$2.4 million, for a net savings of \$1.9 million.¹ Another 18 NSNs were purchased for \$2.5 million that were in excess to requirements. Of the 18 NSNs that were overprocured, 3 items, valued at about \$0.3 million, could not be canceled by the item manager because of extenuating circumstances such as changes in customer demand after an order was placed. The remaining

¹The savings value is less than the value of the procurement action because of costs associated with contract termination.

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15 items, valued at about \$2.2 million, might have been canceled if the item managers had conducted timely reviews. However, item managers indicated that the cost for canceling seven of the excess purchases that were on contract exceeded the benefit to the Government, and the remaining eight items had either already been shipped by the contractor or received by the customer. Table 1 shows the status of the notices of potentially excess procurement in our judgmental sample.

Table 1. Potentially Excess Procurement Sample
(dollars in millions)

<u>Status</u>	<u>NSNs</u>	<u>Value</u>
Incorrect notices	68	\$15.6
Excess purchases received	18	2.5
DISC cancellations	9	0.8
Cancellations resulting from audit	<u>8</u>	<u>2.4</u>
Total	103	\$21.3

Timeliness of Resolving Notices

DLA and DISC did not exercise sufficient management oversight of the contract termination process to ensure the timely resolution of potentially excess procurements. DoD Regulation 4140.1-R requires that notices of potentially excess procurement be resolved within 30 days of the notice. Prompt action is critical as soon as it is realized that previous requirements are no longer valid because contractors continue production and incur additional costs for which the Government is liable. For nearly two-thirds (69 out of 103) of the items, DISC item managers could not document that notices of potentially excess procurement were reviewed within the required 30 days. Of the 69 NSNs, 61 NSNs had no supporting evidence of an item manager review, and 8 NSNs were reviewed after the 30-day review threshold (between 43 and 114 days). Of the 69 NSNs with undocumented or untimely reviews, 22 NSNs, valued at about \$4.6 million, were excess procurements that were not canceled by DISC before the audit.

Although DoD Regulation 4140.1-R requires that ICPs maintain appropriate records to ensure accountability of reduction decisions, neither DLA nor DISC had procedures in place that tracked whether reviews were being conducted in a

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timely manner. Internal DISC policy² also calls for an annotated copy of the notice of potentially excess procurement to be maintained by the item manager. Without the appropriate management emphasis, DISC did not focus on ensuring that item managers reviewed and took action on notices of potentially excess procurement in a timely manner.

Database Maintenance

DISC did not maintain updated, verified, and accurate data in the Standard Automated Materiel Management System (SAMMS) database. Of the 103 notices of potentially excess procurement from the SAMMS database, 68 were incorrect. Outdated and inaccurate data put DISC at risk to make both over- and underprocurements of mission-critical items. The incorrect notices of potentially excess procurement had multiple categories of causes, shown in Table 2, with the largest category being invalid, or false, orders. Of the 68 incorrect notices, 16 were invalid orders. Another 28 NSNs had errors in the demand categories of erratic demand, forecast demand, and special program requirements. Those erroneous notices were generated because item managers did not ensure that the SAMMS database was updated with appropriate data for those types of demands.

Table 2. Sources of Data Inaccuracies
(dollars in millions)

<u>Error Category</u>	<u>NSNs</u>	<u>Value</u>
Invalid order	16	\$ 3.6
Erratic demand	13	3.6
Forecast demand	12	2.5
Special program	3	0.2
Quarterly demand	9	0.8
Minimum buy	6	1.1
Other ¹	<u>9</u>	<u>3.9</u>
Total	68	\$15.6²

¹Other includes incorrect administrative and production lead time, missing data, and pricing errors

²Values do not total due to rounding

²DISC-P Staff Memorandum 4140.21, November 14, 1996, contains procedures for processing items in excess procurement status.

For example, NSN 5365-00887-1488 (turbine torque ring) was one of the items in our sample. It was on the February 1998 list of potentially excess procurements. It had also been on the November 1997 list, with a potential excess of 59 items on order, costing about \$705,500. The SAMMS database had listed the item as potentially excess in November because the demand history data that is used in the SAMMS database as the basis for calculating demand showed a demand for only 14 items for the previous year. As a result, when an order for 59 items was placed, a notice of potentially excess procurement was generated. The item manager had documented a significant increase in customer demand for this item and was ordering accordingly. However, because the item manager did not promptly make adjustments to the SAMMS database, it continued to issue notices of potentially excess procurement. As a result, this NSN appeared again in the February 1998 sample group of potentially excess procurements. It is the responsibility of the item manager to ensure that all data elements in SAMMS are correct.

Contract Reduction Coordinators

DISC and DSCP did not have contract reduction coordinator positions as required by DoD Regulation 4140.1-R. All DoD ICPs are required to have a materiel purchase request and contract reduction coordinator “. . . in a sufficiently high position to ensure management emphasis on prompt reduction [and] cancellation of orders and consideration of terminating items under contract in response to reduction in requirements.” Although the commodity business units within DISC had a “due-in” monitor who ensured that item managers were provided copies of the notices of potentially excess procurement, DISC did not have someone in position to ensure prompt resolution of notices of potentially excess procurement. DSCP was effectively managing excess procurements. However, a contract reduction coordinator would ensure continued DSCP focus on managing excess procurements.

Without a contract reduction coordinator, many NSNs at DISC with notices of potentially excess procurement were not reviewed within 30 days and appeared as potentially excess procurements for multiple months. We compared the list of the NSNs accounting for the 70 highest dollar value notices of potentially excess procurement for November 1997 and February 1998. The comparison showed that 20 of the NSNs appearing on the November list also appeared 3 months later on the February list. The duplicate listings occurred because the notices of potentially excess procurement were not resolved earlier by termination of the procurement or correction of the database to reflect a valid procurement action.

Consumable Item Transfers from Military Departments

The Navy and the Air Force did not exercise sufficient oversight of the Service ICPs to ensure that the joint business rules for managing the transition of CITs from the Service ICPs to DLA were followed. DISC item managers stated that they had difficulty obtaining cancellations for items that were being procured in

Managing Contract Terminations

excess of requirements, as well as obtaining data required for managing CIT items, from Navy and Air Force ICPs. DISC did not report any problems with Army ICPs.

DISC item managers stated that 3 CIT procurement actions from the sample group of 103 NSNs were in excess but had not been canceled by Navy or Air Force contracting officers after the item managers' requests. Although the items had been transferred to DISC for management, the contracts and purchase requests were still managed by the Services rather than by DLA. Under the CIT business rules, agreed upon by DLA and the Services, DLA does not have the authority to require the Services to cancel contracts. However, the Services should cooperate with DLA requests.

During the audit, DISC item managers used our request for information as leverage to obtain cancellations for the three procurements valued at more than \$1 million. For example, the item manager for NSN 3120-01384-9056 (a bearing) was unable to persuade the Air Force to cancel an excess purchase request. When the Air Force contract specialist was informed that the item was being reviewed by the Inspector General, DoD, the purchase request was canceled for a savings of \$256,200.

Related problems with CIT management were also reported in Inspector General, DoD, Report No. 97-226, "Consumable Item Transfer, Phase II, Management," September 30, 1997. Although the focus of the September 1997 audit report was on CIT management rather than the termination process, the report made recommendations addressing the lack of communication of supply management information between DLA and Service ICPs. Specifically, the September 1997 report recommended that the Services advise the DLA ICPs of all delays in and cancellations for CIT, Phase II, purchase requests; expedite contractual orders for transferred CITs; and verify the validity of open purchase requests for Phase II consumable items. The Navy and the Air Force concurred with these recommendations. The Navy stated that on June 9, 1997, Naval Supply Systems Command directed the Navy ICP to ensure the most current demand history, procurement actions, and requirements were provided to DLA.

However, the same conditions of Navy and Air Force CIT information sharing were also identified in the first report in this series, Inspector General, DoD, Report No. 98-172, "Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond," July 2, 1998. Both the Navy and the Air Force concurred with the recommendations in the report, stating that their item managers will follow appropriate business rules and provide information necessary for making termination decisions. This report does not make additional recommendations.

Previous Management Issue

DLA had not corrected a material management control weakness on untimely contract terminations that it reported in each of its annual statements of assurance since FY 1993. Inspector General, DoD, Report No. 93-146,

“Contract Terminations at DoD Wholesale Inventory Control Activities,” June 30, 1993, recommended that DLA “. . . develop controls over the evaluation of termination candidates and a system to ensure the timeliness of termination actions.” In addition, the June 1993 report identified the lack of controls as a management control deficiency. The report states that “. . . internal controls were not established to ensure that appropriate and prompt actions were taken to reduce the quantity of materiel on contract that were not needed.”

To correct the material management control weakness, DLA issued guidance to its ICPs in a memorandum, “Terminations,” June 21, 1993. The memorandum requested that the ICPs provide data on procurement actions to DLA headquarters on a monthly basis to facilitate an accurate account of the effects of termination and cancellation actions on the DLA inventory reduction program. The June 1993 memorandum was followed up with detailed instruction in an August 3, 1993, memorandum. However, during our first audit in this series, Report No. 98-172, “Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond,” July 2, 1998, we reported that DLA no longer maintained the data on terminations and no guidance was in place that focused on termination procedures. DLA materiel management personnel explained that although the requirement to maintain termination data had not been formally canceled, the data were no longer being submitted by the ICPs.

DSCP Management of Contract Terminations

The item managers in the Clothing and Textile Directorate at DSCP were performing and documenting the reviews required to determine if procurement actions were in excess of requirements. We used the SAMMS database to select a judgmental sample over two time periods to evaluate the contract termination process at the Clothing and Textile Directorate. Our evaluation of a judgmental sample of 67 NSNs, valued at \$71.6 million, showed no instances of excess procurement. As a result, we concluded that DSCP was effectively managing its items to avoid procuring materiel in excess of requirements.

Clothing and Textile Directorate Analysis. We focused our analysis on the Clothing and Textile Directorate at DSCP because we determined the other two directorates at DSCP--medical and subsistence--were using best commercial business practices of direct vendor delivery. The Clothing and Textile Directorate used the DSCP Automated Inventory Management System and spreadsheets as a management tools for managing notices of potentially excess procurement. The use of SAMMS was suspended at DSCP because the database was not only inaccurate but it was also inappropriate for managing clothing and textile items that had multiple NSNs representing many different sizes for a single item. For example, NSN 8405-01377-9325 (man’s coat) had 63 associated NSNs that represented size variations.

Initial Review. For our initial review of the Clothing and Textile Directorate, we reviewed the 50 highest dollar potentially excess procurements, valued at about \$38.5 million, for February 1997. The Clothing and Textile Directorate

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had 835 NSNs potentially in excess, valued at \$67.9 million, during February 1997. The February 1997 list was the most current at DSCP because SAMMS had been deactivated. We interviewed each item manager and determined through our review of the alternate methods, including spreadsheets, that none of the NSNs were being procured in excess.

Additional Review. DSCP activated the SAMMS database in February 1998. From a total of 1,451 potentially excess procurements, valued at \$108.3 million, for November 1997 and January 1998, DSCP provided us listings of 150 high-dollar value potentially excess procurements at the Clothing and Textile Directorate. From those lists, we selected a judgmental sample of 17 high-dollar NSNs that we had not reviewed in our initial sample. Those 17 NSNs, valued at \$33.1 million, were associated with 143 additional NSNs representing various sizes of base NSNs. Although the SAMMS database was inaccurate and DSCP lacked a contract reduction coordinator, we found no instances of excess procurement for the 17 NSNs in the November 1997 or January 1998 sample group of items because the DSCP item managers were effectively using the alternate methods.

Reductions in Excess Procurements

Procurement of excess materiel by DISC resulted in lost opportunities to reduce the DoD inventory as well as lost opportunities to put funds to better use. DISC procured materiel in excess of requirements for 15 NSNs, valued at \$2.2 million, in our sample group of 103 NSNs.

Procurement Terminations. As a result of the audit, DISC canceled eight procurements, valued at \$2.4 million, for a net savings of \$1.9 million. Prior to our audit, DISC terminated 9 of the 103 potentially excess procurements in our sample group. Those nine terminations had a value of about \$765,100. If DISC had increased its management emphasis on resolution of notices of potentially excess procurement, it may have terminated 15 additional procurements valued at \$2.2 million. None of the 15 NSNs had evidence of a timely review by item managers. The procurements could not be canceled at the time of our audit because they had been shipped or received, or the contract cancellation costs exceeded the benefit to the Government.

Inventory Reduction. Reducing DoD supply inventories by \$12 billion by the year 2000 is a National Partnership for Reinventing Government High Impact Agency goal, which is part of the DoD plan for implementing the Government Performance and Results Act. Improving DLA management of terminations of excess procurements will contribute toward the DoD goal of inventory reduction. Management actions initiated by DLA and DISC during the audit will correct problems we identified with timely reviews and database maintenance.

DLA and DISC Management Actions

We commend DLA and DISC for taking positive management actions during the audit to correct procedures. Both DLA and DISC issued policy to improve procedures for the prompt review of potentially excess procurements. As a result of the management actions, we do not make recommendations to DLA or DISC to improve procedures for ensuring prompt review of potentially excess procurements.

DLA Policy. The Commander of the Defense Logistics Support Command issued a memorandum on April 30, 1998, "Overprocurements," that acknowledges the need for DLA to improve performance in controlling excess procurements. The full text of that memorandum is in Appendix D. The memorandum establishes a goal of no more than 3 percent for overprocurements³ by the end of FY 2000. The memorandum also requires that the DLA ICPs:

- conduct analyses to determine the appropriate thresholds for review of excess procurements;
- provide quarterly data to headquarters on the amount of due-in stock that appears as excess procurement in the DLA stratification reports;
- provide quarterly data to headquarters on the dollar value of procurements referred to item managers for review;
- provide quarterly data to headquarters on the dollar value of procurements that item managers requested to be canceled;
- provide quarterly data to headquarters on the actual value of cancellations; and
- review the criteria used in the automated recommended buy approval process.

DISC Policy. As a result of our discussions with DISC management, DISC issued a policy memorandum, "Termination Decision Model," May 7, 1998, detailing actions required to improve the working of termination actions at DISC. The policy included:

- mandatory monthly review of the top 100 items having a notice of potentially excess procurement;
- completion of all actions in the termination process within 30 days, to include file maintenance and pre- and post-award actions;

³DLA calculates overprocurement by comparing the total value of materiel on order and in stock with the demand for materiel. Data from the DLA stratification report, a compendium of inventory records as well as the SAMMS database records, is used in the calculations.

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- ensuring asset visibility for valid forecasts of demand by loading the data into “other non-recurring demands” category within SAMMS and correcting quarterly demand forecasts and numeric stock objectives; and
- documentation of all decisions and actions taken.

Recommendations and Management Comments

We recommend that the Director, Defense Logistics Agency:

- 1. Develop procedures and controls to ensure that the Standard Automated Materiel Management System database is updated, verified, and accurately maintained to reflect the most current information.**
- 2. Establish contract reduction coordinator positions at the Defense Logistics Agency inventory control points, as required by DoD Regulation 4140.1-R.**

Management Comments. The Defense Logistics Agency concurred and stated that the Defense Logistics Support Command issued additional guidance to the Defense Logistics Agency supply centers on August 10, 1998, addressing both areas of concern. The FY 1999 material control objective on overprocurement terminations is geared to track DLA supply center implementation of this guidance.

Part II - Additional Information

Appendix A. Audit Process

Scope

We performed the audit at DLA headquarters and two DLA ICPs: DISC and DSCP. We reviewed documents dated from January 1993 through March 1998 that included:

- DoD regulations and DLA procedures and practices on materiel management;
- DoD policies, procedures, and practices for inventory reduction and the review and cancellation of procurements of excess materiel;
- supply studies containing notices of potentially excess procurement for a judgmental sample of 103 NSNs, valued at \$21.3 million, at DISC and 67 items, valued at \$71.6 million, at DSCP;
- ICP item manager supply system studies;
- monthly ICP summary reports of excess procurements and contract and purchase requests terminated;
- business rules for CIT items;
- documents describing the contract termination model (Termination for Convenience Decision Support Model) used to prepare notices of potentially excess procurement; and
- DLA correspondence that authorized the review thresholds of potential dollar value cited in the budget execution plans.

DoD-Wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance and Results Act, DoD 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 objective and goal.

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

GAO High Risk Area. The GAO has identified several high risk areas in the DoD. This report provides coverage of the Defense Infrastructure and Defense Inventory Management high risk areas.

Methodology

We reviewed DoD, DLA, DISC, and DSCP policies and procedures for evaluating notices of potentially excess procurement. We also interviewed personnel at DLA, DISC, and DSCP regarding internal policies and procedures for managing excess procurements and terminating purchase requests and contracts. We performed an in-depth review of 103 notices of potentially excess procurement at DISC and 67 notices of potentially excess procurement at DSCP. Our review also included interviews with item managers, contracting officers, and supervisors at the ICPs to clarify the data in the notices of potentially excess procurement and to obtain supporting rationale for decisions to terminate or not terminate the procurements. As a method of verifying the data in the notices of potentially excess procurement, we independently calculated the value of the stock objective using demand history, lead times, procurement cycles, and safety levels obtained from the termination model and item managers.

We issued a standard memorandum to item managers and their supervisors for 27 NSNs that lacked sufficient information to determine if the procurement action was in excess of requirements. The memorandum requested additional information about the NSNs, including the required stock objective, a determination of whether the quantities being procured were excessive, an explanation of why the procurement in question should or should not be terminated, and an explanation of the quantity terminated and the associated dollar savings. We reviewed item manager responses to the memorandums to determine if sufficient documentation was provided to justify the continued procurement. Timeliness of review of notices of potentially excess procurement was determined by comparing the date of the notice of potentially excess procurement and date of the item manager's review.

Use of Computer-Processed Data. To achieve the audit objective, we relied on computer-processed data from the termination model that is a subroutine of SAMMS to identify the universe of excess procurements. Our review of the contract termination model was limited to descriptive documents and observing the results of the model on notices of potentially excess procurement. We did not review the equations used by the model, nor did we review the programming for the model. Although we requested information on the equations and the programming used in the model during our audit, DLA was unable to provide the information. We did not review the DSCP-specific materiel management system, the Automated Inventory Management System.

Appendix A. Audit Process

Universe and Sample. The universe of potentially excess procurements at DISC consisted of the notices of potentially excess procurement provided by the SAMMS-based termination model at DISC for February and March 1998. DISC had 4,800 purchases in progress for materiel that potentially exceeded requirements during the 2-month period, valued at about \$48.9 million. From that universe, we judgmentally selected for review a group of 103 potentially excess procurements that had a dollar value of \$21.3 million. The judgmental sample was based on selecting the highest dollar value notices of potentially excess procurement, which accounted for approximately 44 percent of the total dollar value of notices of potentially excess procurement for each of the 2 months. The high-dollar items were selected because they offered the potential for the greatest savings. The value of the procurement actions in the sample group ranged from a high of \$2.5 million to a low of \$15,000.

The universe of potentially excess procurements at DSCP covered two time periods. Initially, we obtained a list of 50 NSNs that represented the highest dollar value of potentially excess procurements out of a total of 835 potentially excess procurements for February 1997. Those 50 NSNs, valued at \$38.5 million, represented less than 6 percent of the total number of potentially excess procurements but accounted for nearly 57 percent of the total dollar value during February 1997. DSCP had 1,451 potentially excess procurements for November 1997 and January 1998, valued at \$108.3 million. We obtained lists of 150 of those high-dollar value potentially excess procurements and judgmentally selected 17 NSNs, valued at \$33.1 million, for review. That amount represented about 31 percent of the total value of potentially excess procurements for the 2 months.

Use of Technical Assistance. The Technical Director and an operations research analyst from the Quantitative Methods Division, Office of the Assistant Inspector General for Auditing, DoD, assisted in reviewing the universe of items provided by DISC and DSCP. The Quantitative Methods Division also reviewed documents about the termination model provided to us by DLA.

Audit Type, Dates, and Standards. We performed this economy and efficiency audit from February through June 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

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

Management Control Program

We did not include tests of management controls because the management control program applicable to the overall objective was covered in the first audit in this series, Inspector General, DoD, Report No. 98-172, "Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond," July 2, 1998. The report states that DLA identified timeliness of contract terminations as an assessable unit. It was listed as a material weakness

Appendix A. Audit Process

in the FY 1997 statement of assurance as well as each statement of assurance since FY 1993. Although progress in correcting the weakness was reported in each of the annual statements since FY 1993, DLA had not corrected the material weakness.

Appendix B. Summary of Prior Coverage

During the past 5 years, the GAO; the Inspector General, DoD; and the audit organizations of the Military Departments issued 8 reports and provided congressional testimony that discussed various elements of requirements determination and controls over potential contract terminations. We have listed the prior coverage below.

General Accounting Office

GAO Report No. NSIAD-98-86 (OSD Case No. 1565), "Navy Inventory Management," April 30, 1998.

GAO Testimony NSIAD-T-97-109, "Defense Inventory Management: Problems, Progress, and Additional Actions Needed," March 20, 1997.

GAO Report No. GAO/HR-97-5, "Defense Inventory Management," February 1997.

GAO Letter Report No. GAO/HR-97-1, "High Risk Series: An Overview," February 1, 1997.

Inspector General, DoD

Inspector General, DoD, Report No. 98-172, "Contract Terminations at Defense Supply Center Columbus and Defense Supply Center Richmond," July 2, 1998.

Inspector General, DoD, Report No. 97-226, "Consumable Item Transfer, Phase II, Management," September 30, 1997.

Army Audit Agency

U.S. Army Audit Agency Report No. AA 98-53, "Contract Termination Process, U.S. Army Communications-Electronics Command Fort Monmouth, New Jersey," December 23, 1997.

Naval Audit Service

Naval Audit Service Report No. 003-97, "Terminations of Contracts for Spare Parts at the Naval Inventory Control Points," October 15, 1996.

Air Force Audit Agency

Air Force Audit Agency Report No. 97064010, "Air Logistics Center Contract Terminations," January 23, 1998.

Appendix C. Contract Termination Guidance

Materiel Management Guidance. DoD policy on contract terminations is contained in DoD Regulation 4140.1-R, "DoD Materiel Management Regulation," January 25, 1993. The Regulation states that ICPs will maintain appropriate records to ensure accountability of reduction decisions and the coordination of reduction decisions across functional areas. Reduction decisions are to be reached and implemented in a timely manner, normally within 30 days of generation of a notice of potentially excess procurement. Item managers and contracting officers are primarily responsible for termination actions. The Regulation requires that termination action shall be pursued if determined to be cost-effective and in the best interest of the Government. DoD Regulation 4140.1-R also states that, prior to contract award, item managers should place particular emphasis on validating requirements data used as the basis for orders exceeding \$25,000.

Consumable Item Transfer Guidance. Additional guidance for materiel management was established by formal business rules for CITs. Those business rules were established in response to the restructuring and consolidation of Military Department materiel management functions under DLA. The rules specifically require that DLA not dispose of materiel transferred by the Military Departments until at least 2 years have passed from DLA assuming management of the item, unless the Military Department gives prior approval. The business rules precluding disposals do not prevent DLA from recommending that the Military Departments terminate excess procurements of CITs. The business rules require that DLA item managers ensure that all data, to include item manager folders and program-driven requirements information, have been considered prior to requesting cancellation or termination of any purchase request as a result of a notice of potentially excess procurement.

Item Manager Responsibilities. The SAMMS database provides the input for the model that generates notices of potentially excess procurement to item managers. The notices recommend the reduction of purchase request or contract quantities when requirements decrease and the quantities on hand and on order exceed the quantity authorized for stockage of a particular item. Item managers are required by DoD Regulation 4140.1-R to verify data used in the requirements computation to ensure that the automated system's identification of candidates for procurement reduction or total termination of an excess quantity was appropriate. If assets on order after validation are excessive, the item manager is to recommend to the contracting officer reduction or cancellation of any excess quantity that is on a purchase request in process. If materiel is on contract, the item manager is to determine whether termination of the excess on-order assets would be in the best interest of the Government.

According to the guidance in DoD Regulation 4140.1-R, cost-effectiveness, after contract award, should be determined by a comparison of what it will cost to hold items in inventory versus the cost to terminate the same items from contracts, plus reprocurement costs, if

Appendix C. Contract Termination Guidance

known. If the item manager review of a notice of potentially excess procurement determines that a termination action would be economical, the item manager is to request the contracting officer to consider terminating the excess quantity of materiel on contract.

Contracting Officer Responsibilities. DoD Regulation 4140.1-R requires that the contracting officer promptly reduce or cancel orders before contract award if requested by the item manager as a result of requirements analysis. After contract award, the contracting officer is to validate the cost-effectiveness of contract termination to ensure that cancellation is in the best interest of the Government. The Federal Acquisition Regulation, subpart 49.101, "Authorities and Responsibilities," requires that contracting officers terminate unneeded materiel from contracts when it is in the Government's best interest. The contract termination model that generates the notices of potentially excess procurement was designed to assist in that determination. DoD Regulation 4140.1-R requires followup action on all requests for reduction or cancellation of contracts or purchase requests to ensure that award quantities reflect reductions in requirements.

Appendix D. Defense Logistics Support Command Memorandum



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

APR 30 1988

IN REPLY
REFER TO DLSC-LS

MEMORANDUM FOR COMMANDER, DEFENSE SUPPLY CENTER COLUMBUS
COMMANDER, DEFENSE SUPPLY CENTER PHILADELPHIA
ADMINISTRATOR, DEFENSE INDUSTRIAL SUPPLY CENTER
COMMANDER, DEFENSE SUPPLY CENTER RICHMOND

SUBJECT: Overprocurements

DLA failed to show improvement in overprocurement statistics in FY 97; we actually lost ground. This is a serious matter. A recent DoDIG draft report on this subject was highly critical, and we have come under intense scrutiny by Congressional Committees. Poor performance in this area will be seen as evidence that we have stopped paying attention to the potential build-up of future excess inventory. It is one of the most potentially damaging indicators we can produce. Accordingly, we will initiate a program to improve and track our performance.

a. Thresholds for reviewing overprocurements must be revisited. Set too high, the thresholds keep workload down but allow too many buys to go unchallenged. Set too low, they create a workload problem and may cause improper cancellations. You should conduct an analysis to determine the settings. We need to be able to justify our decisions to the various audit teams and committees.

b. We must get back to keeping score. The following information will be provided to DLSC-LS within 30 days after the end of each calendar quarter:

(1) From the SAMMS Stratification Program, the amount of due-in stock that stratifies as overprocured and the total amount of due-in stock.

(2) From the Due-In Terminator Program, the dollar value that was referred to the Item Managers (IM) for review, the value of Procurement Request (PR) and contract dues-in that the IMs requested to cancel, and the amount of that universe that was actually canceled.

(3) Copies of the monthly SAMMS PF-33-2 Reports, Summary of Purchase Requests Canceled

c. You should conduct an examination of the workflow and workload associated with canceling contracts. Is the post-award area sufficiently staffed and supported? Past management reviews have indicated that this may be a weak area.

d. Examine your automated recommended buy approval process. How much of your overprocurements are due to automated buy approval? Do you need to change your criteria?

Appendix D. Defense Logistics Support Command Memorandum

APR 0 1998 2

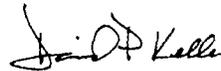
At the end of this fiscal year, I expect you to be at or below your negotiated FY 98 goals for non-CIT overprocurements, which are as follows:

<u>CENTER</u>	<u>FY 98 Goal</u>	<u>FY 97 Actual</u>
DSCC	3.5% (excludes DMS)	3.9%
DISC	3.8%	4.5%
DSCP (C&T)	2.0%	8.2%
DSCP (Med)	4.0% (excludes warstoppers)	6.5%
DSCR	5.8% (excludes ODS and DMS)	6.5% (adjusted)

I also expect you to set a course to reach a permanent level of overprocurements no higher than 3% by the end of FY 00. The focus of your plan should not be increased cancellations, but better controls up front to reduce the likelihood of future overprocurements. This will include, but not be limited to, improving requirements and asset file maintenance, confirming additive requirements before buying, reducing leadtimes to permit buying closer to the point of sale, and tightening up scrutiny of adjustments to recommended buy quantities. First-line supervisors without inventory management backgrounds need to get up to speed quickly on this last item.

In the very near future, a working level group will meet to address the concerns raised by the DoDIG's draft report and to review the overprocurement process. I want you to give this effort your strongest possible support.

I cannot overemphasize the importance of this problem. It deserves your immediate attention and dedicated effort. The long-term impact of a bad report card on this one statistic could be painful and long lasting. We will be providing Center overprocurement information to the Business Office to use in determining whether materiel funding should be reduced. If we do not enforce these goals, Congress will. I would rather endure a small, short-term risk to supply support than a return to the low materiel replacement rates of recent years.



DAVID P. KELLER
Rear Admiral, SC, USN
Commander

Appendix E. Report Distribution

Office of the Secretary of Defense

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Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
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House Subcommittee on National Security, Committee on Appropriations
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House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

Part III - Management Comments

Defense Logistics Agency Comments



IN REPLY
REFER TO

DDAI

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
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SEP 8 0 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: OIG Draft Report, "*Contract Terminations at Defense Industrial Supply
Center and Defense Supply Center Philadelphia.*"
(Project No. 7LD-3011.01)

This is in response to your August 4, 1998 request. If you have any questions,
please contact Ms. Annel Williams, 703-767-6274.

Encl


JEFFREY GOLDSTEIN
Chief (Acting), Internal Review Office

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Defense Logistics Agency Comments

SUBJECT: Contract Terminations at Defense Industrial Supply Center and Defense Supply Center Philadelphia

FINDING: Managing Contract Terminations (See page 4 of the Draft Report)

DLA COMMENTS: Concur. The audit report acknowledges the positive steps taken to correct previous transgressions and prevent their reoccurrence.

RECOMMENDATION: Recommend that the Director, Defense Logistics Agency:

1. Develop procedures and controls to ensure that the Standard Automated Materiel Management System database is updated, verified and accurately maintained to reflect the most current information.
2. Establish contract reduction coordinator positions at the Defense Logistics Agency inventory control points, as required by DoD Regulation 4140 1-R

DLA COMMENTS: Concur. The Defense Logistics Support Command issued additional guidance to the DLA centers on August 10, 1998, (attached) addressing both areas of concern. Our FY 99 Materiel Control Objective on Overprocurement Terminations is geared to track Center implementation of this guidance.

DISPOSITION: Ongoing ECD: December 1998

ACTION OFFICER: Mr. Bob Theiss, DLSC-LS, (703)767-1611

REVIEW/APPROVAL: Mr. Walter B. Bergmann, II, Deputy Executive Director,
Logistics Management (DLSC-L), September 23, 1998

COORDINATION: Ms. Annell W. Williams, DDAI

DLA APPROVAL:



V.R. CHAMMESWAIN
Rear Admiral, SC, USN
Deputy Director

Defense Logistics Agency Comments



DEFENSE LOGISTICS AGENCY
DEFENSE LOGISTICS SUPPORT COMMAND
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AUG 10 1998

IN REPLY
REFER TO

DLSC-LS

MEMORANDUM FOR COMMANDER, DEFENSE SUPPLY CENTER COLUMBUS
COMMANDER, DEFENSE SUPPLY CENTER PHILADELPHIA
ADMINISTRATOR, DEFENSE INDUSTRIAL SUPPLY CENTER
COMMANDER, DEFENSE SUPPLY CENTER RICHMOND

SUBJECT: Strengthening the Overprocurement Termination Process

The attached guidance strengthens the overprocurement termination process by augmenting direction provided in the April 30, 1998, DLSC letter, Subject: Overprocurements. It specifically addresses recent DoD Inspector General audit criticisms by bringing DLA into compliance with DoD 4140.1-R "DoD Materiel Management Regulation" policy. The attachment incorporates approaches developed at a joint April 1998 Overprocurement Workshop of Center and Headquarters representatives.

The guidance provides for stronger program management of the overprocurement termination process by establishing a coordinator at each Center, as required by DoD policy. Each Center should identify its coordinator to Ms. Lynn Fulling, DLSC-LS, email: Lynn_Fulling@hq.dla.mil, DSN 427-1615, by COB August 14, 1998.

It is imperative that DLA has an effective overprocurement termination program to preclude any perception of mismanagement. I am confident that your strong support in implementing this guidance, in conjunction with the April 30, 1998, direction, will result in an effective, integrated process preventing investment in excess inventory.

DAVID P. KELLER
Rear Admiral, SC, USN
Commander

Attachment

Strengthening the Overprocurement Termination Process

A Providing a Program Management Approach

- 1 The Centers must maintain an integrated, effective overprocurement termination program to ensure the Agency is achieving the lowest possible rate of overprocurement. To facilitate this, each DLA Center will establish a single coordinator with overall responsibility for the overprocurement termination program. This individual will be in a sufficiently high management position to maintain continued emphasis on prompt response to potential overprocurement situations.
- 2 Each Center coordinator shall ensure Center-developed strategies are in place in a timely fashion to achieve the target overprocurement percentage (overprocurement due in stock/total due in stock) provided in the Annual Performance Plan.
- 3 The Center coordinator shall serve as a focal point for responding to questions and reporting on Center overprocurement termination processes and goals.
- 4 Each Center coordinator shall facilitate close liaison with other Centers to share problems and solutions. This is especially critical to the development of computer tools to streamline the existing process.

B Ensuring Timely Processing

- 1 Timely processing is essential. Generally, each Center should strive for a maximum 30 day process from the time the Reason for Study Code "DI"/ Termination Decision Model (TDM) data are generated to the time of the decision to terminate or not terminate the contract.
- 2 It is recognized that current resource demands and the high incidence of Consumable Item Transfer (CIT) NSNs makes this timeframe a challenge. Nevertheless, each Center shall implement tracking mechanisms to measure actual process time. The resulting data will provide an empirical basis for improving the process or for justifying the process timeframes extending beyond the 30 day target.
- 3 Where practical, Center experience should be applied to process overprocurement candidates first that exhibit characteristics for greater cancellation potential, e.g., items in Recommended Buy/ Purchase Request status, or recently negotiated contracts where the contractor may not have already made major resource investments. Potential cost avoidance should also be a criterion for prioritizing workload.

Defense Logistics Agency Comments

C Eliminating Extraneous Overprocurement Candidates

- 1 The current process is hindered by a large volume of extraneous candidate items generated due to erroneous or missing requirements or due-in data. This process, which was intended to identify potential overprocurement, has become a major source of identifying/ correcting inaccurate data. This becomes problematic when this high visibility process produces unnecessary workload, invalid statistics, and the resulting perception of mismanagement.
- 2 To correct this inaccurate data problem, process data; e.g., workload distribution, process codes, Inventory Manager (IM) annotations, should be analyzed to identify areas where attention/ additional training may be needed.
- 3 The lack of accurate, current data may result from IM attempts to cope with increased workloads by foregoing file maintenance of the data base. This short-term time savings is lost in the long run when the management-by-exception based automated system cannot operate effectively and IM intervention is eventually required.

D Maintaining Effective Supervisory Review

- 1 Generally, the level of supervisory review of overprocurement termination process decisions should be consistent with buy decisions. The intensity of reviews should not be influenced by the existing level of funding. Ready availability of funds should not diminish efforts to address potential overprocurement termination.
- 2 Review of cancellations is important to preclude adverse customer support situations resulting from inappropriate terminations. Similarly, supervisory oversight of decisions not to terminate is essential to maintain program/ procedural integrity and isolate problems and identify the need for additional training.
- 3 The supervisor also plays a pivotal role in ensuring that strategies to minimize overprocurement situations are developed and implemented effectively.

Audit Team Members

This report was produced by the Readiness and Logistics Support Directorate,
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