

GAO

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Report to Congressional Requesters

June 1988

INTERNAL CONTROLS

Controls Over Material Furnished to Navy Contractors Can Be Improved



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Washington, D.C. 20548

**National Security and
International Affairs Division**

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The Honorable Pete Wilson
United States Senate

The Honorable John Glenn
Chairman, Committee
on Governmental Affairs
United States Senate

As requested in Senator Wilson's letter of April 15, 1986, we reviewed the Navy's controls over material furnished to contractors from all sources, including the Department of Defense's supply system. This is one in a series of reports related to the effectiveness of defense logistics.

As arranged with your Offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to interested committees and other members of the Congress; the Secretary of Defense and the Navy; and the Director, Office of Management and Budget. We will also make copies available to other parties upon request.

A handwritten signature in cursive script that reads "Frank C. Conahan".

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

Each year the Department of Defense (DOD) provides billions of dollars in material from its supply system to contractors to produce and maintain items, or to provide various services for the Armed Forces. Senator Wilson and Senator Glenn, Chairman of the Senate Committee on Governmental Affairs, requested that GAO examine DOD and military service policies, procedures, and practices for acquiring and controlling this government-furnished material (GFM). This report focuses on the U.S. Navy and examines

- its compliance with requirements to justify and document decisions to provide material to contractors,
- the adequacy of management controls established to validate and approve contractor GFM requisitions, and
- the adequacy of government oversight over GFM in the possession of contractors.

GAO has issued separate reports on the Army and Air Force controls over and accountability for GFM.

Background

GFM includes parts, assemblies, and raw and processed materials used in research, development, production, maintenance, and repair of final products, such as tanks, aircraft, and ships. GFM is also used to support services provided by contractors at military installations. Under the Federal Acquisition Regulation, contractors are generally required to provide material to complete a product and fulfill their contracts; however, the government provides GFM when it is considered to be in its best interest. As of September 30, 1980, DOD estimated that U.S. Navy contractors held about \$6.2 billion of GFM.

The Navy allows contractors to requisition GFM directly from the DOD supply system by giving them special identification codes or by allowing them to submit GFM requirements lists to Navy officials who approve and submit requisitions to the DOD supply system. The Navy also allows contractors to buy authorized GFM items from commercial sources.

Since the mid-1970s, GAO, DOD, and Navy audits have identified significant problems in DOD's management and control of GFM. In July 1978, the House Committee on Appropriations recommended that DOD test a system that would allow contractors to buy materials from its supply system. However, contractors were reluctant to participate because of financial risk. In 1981, DOD directed each service to establish one or more

management control activities to maintain central control over maintenance contractors' access to the supply system. In March 1986, DOD expanded the management control activity concept to include production, research and development, and service contracts.

The Navy has reported the management of GFM as a material internal control weakness in its fiscal year 1985, 1986, and 1987 reports to DOD, which are required by the Federal Managers' Financial Integrity Act of 1982. The 1987 report said that some corrective actions had been completed and others are in process.

Results in Brief

Navy organizations have not complied with DOD instructions requiring that the decision to provide GFM be based on sound rationale and be documented before awarding a contract. In some cases, contractors were authorized to requisition GFM without the Navy making a best interest determination, even though commercial sources could provide the materials.

The Navy has made little progress in implementing DOD policies for adequately controlling GFM provided to contractors. Also, Navy contractors did not have effective property control systems, and government oversight of these control systems was inadequate. Finally, the Navy has made only limited progress in developing and implementing property accountability and financial accounting systems that would adequately account for the material provided to and used by contractors. These control weaknesses could result in the failure to report GFM valued in the millions of dollars as potential excess material being held by contractors and increase the potential for fraud, waste, and abuse.

GAO's Analysis

GFM Provided Without Adequate Justification

Even though it is government policy that contractors provide their own material unless otherwise justified, the Navy has routinely provided GFM, including readily available commercial items such as office supplies, without adequate justification or evaluation. This situation occurred in part because the Naval Supply System Command's Aviation Supply Office provided contractors all materials necessary for contract performance. Reasons given for this included economy and expedited

repair. However, Supply Office personnel provided no written evidence of any analysis supporting their decisions in specific situations.

Management Control Activities Required by DOD Not Fully Implemented

In March 1981, DOD directed the services to establish management control activities to provide management control and reporting systems pertaining to maintenance contractors' access to the supply system. DOD expected the services to implement the management control activity concept by November 1982; however, as of January 1988, the Navy had not yet fully implemented the concept. For example, at the time of our review, the Supply Office's management control activity did not control GFM requisitions for 80 of 117 maintenance contracts. In March 1986, DOD expanded the scope of the management control activity directive to include all contracts. In January 1988, the Navy prepared a comprehensive draft instruction which, if properly implemented, will improve existing GFM control procedures for all contracts. However, no target date for implementation has been established.

Management and Accounting Controls Over GFM Inadequate

The Federal Acquisition Regulation, Navy directives, and contract provisions prescribe that contractors are responsible for establishing and maintaining adequate property control systems to account for, control, and safeguard GFM. Weaknesses in contractor controls over GFM have been repeatedly reported in past audits and problems in this area continue. For example, contractors did not conduct required annual GFM inventories or record all GFM on hand, removed, or transferred. Since 1985, GAO and Naval Audit Service reviews of GFM in the possession of contractors identified over \$286 million of GFM as being potentially in excess of needs. Some of this material could have been used to satisfy other requirements. For example, after GAO identified \$8.5 million potential excess GFM under one contract, the contractor reviewed his GFM inventory and identified \$5.8 million as excess and cancelled \$4.3 million of material requisitions.

Government property administrators did not always provide adequate oversight of GFM held by contractors. The administrators did not perform required annual property surveys and report contractor property control system deficiencies, and contractors did not take corrective actions on recurring problems. Some of these problems were due to a lack of property administration personnel. For example, the Long Beach Naval Regional Contract Center had no assigned property administrators and had to rely on the military installations it served to provide

property administration. Of the 120 military installations served, only one had a property administrator.

Since 1967, DOD and the services have been criticized for not having established property accountability and financial accounting controls over GFM. We recommended in 1980 that accounting systems be established that adequately account for the quantity and value of GFM authorized and provided to contractors and use of the material by the contractors. DOD took action on these recommendations. The Navy has taken some steps to improve property accountability over GFM. However, much more needs to be done in the areas of contract and property administration. In the area of financial accounting for GFM, the Navy has not yet met DOD's accounting manual requirements.

Recommendations

GAO recommends that the Secretary of the Navy

- require decisions to allow contractors to obtain GFM to be justified in advance and adequately documented to demonstrate that they are in the government's best interest from a cost-effectiveness or other critical standpoint;
- ensure that Navy contractors and organizations fully comply with and enforce the Federal Acquisition Regulation and DOD and Navy policies on authorizing, issuing, and overseeing GFM;
- further improve accountability for GFM and implement the financial accounting system required by DOD; and
- continue reporting controls over GFM as a material weakness area in the annual Federal Managers' Financial Integrity Act report to DOD until corrective actions are completed.

Agency/Contractor Comments

We received official oral comments from DOD and written comments from three contractors. These comments were incorporated, where appropriate, in the report. DOD generally concurred with our findings and recommendations and outlined corrective actions to be taken by DOD and the Navy.

We believe that the proposed actions, if implemented properly and in a timely fashion, will help to alleviate the long-standing problems pertaining to the management controls, accountability, and financial accounting for GFM.

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Abbreviations

ASO	Aviation Supply Office
DOD	Department of Defense
DODI	Department of Defense Instruction
FAR	Federal Acquisition Regulation
GFM	Government-furnished material
MCA	Management control activity
NAVPRO	Naval Plant Representative Office

Introduction

On May 23, 1986, we issued a report on problems we identified in Department of Defense (DOD) inventory management practices.¹ As a result of that report, Senator Pete Wilson, then Chairman of the Senate Committee on Armed Services' Task Force on Inventory Management, requested that we identify the magnitude of those problems. Subsequently, Senator John Glenn, Chairman, Senate Committee on Governmental Affairs, made the same request.

One of the problems we identified involved controls over contractor access to the DOD supply system. This problem caused concern because a large number of contractors have had almost unlimited access to government-furnished material (GFM) provided through the supply system.

Government-Furnished Material

GFM consists of assemblies, components, parts, and raw materials that may be incorporated into an end item, such as an aircraft or ship, or consumed in performing a contract. GFM, with few exceptions, is provided without cost to the contractor, and its cost to the government is not usually included in the contract price. When GFM is issued to the contractor, DOD considers it expended and generally deletes it from government records. The contractor then becomes responsible for maintaining the government's accountable records for the GFM in its possession. The exact amount of GFM currently in the possession of DOD contractors is unknown; however, DOD estimated (as of September 30, 1980) that it was about \$14 billion.² Of that total, about \$6.2 billion was estimated to be with Navy contractors.

As one means of accomplishing its mission, the Navy contracts with private companies to produce, maintain, and repair its equipment and to provide services to support the Navy worldwide. The Navy may elect to furnish from DOD inventories the parts and other materials necessary to perform these contracts. The Navy's Aviation Supply Office (ASO), for example, authorizes GFM in its contracts for maintenance and repair of aircraft and their components. Also, Navy commands and bases authorize GFM for contractors that provide such services as producing and

¹Inventory Management: Problems in Accountability and Security of DOD Supply Inventories (GAO/NSIAD-86-106BR, May 1986).

²We testified in a hearing before the House Committee on Government Operations on March 6, 1985, that this figure was probably understated. On February 6, 1987, we asked DOD for an update of this figure. However, on April 9, 1987, DOD replied that although such data have not been collected by DOD and the services, actions were underway to do so. In February 1988, DOD provided us with its results. DOD estimated that as of September 30, 1986, the DOD total had grown to about \$16.1 billion and the Navy total to about \$7.7 billion. DOD also informed us that the totals included material acquired by contractors from commercial sources with government funds.

maintaining weapons systems, maintaining base equipment and facilities, and supporting test range operations.

To enable contractors to obtain GFM, the Navy assigns them DOD Activity Address Codes, which allow access to the DOD supply system. As of May 1987, the Navy had assigned over 1,000 of these codes to various contractors. Contractors can use their codes and follow standard DOD requisitioning procedures to obtain materials directly from the government supply system.³ Contractors can also obtain GFM by submitting requirements lists to Navy officials, who approve, prepare, and submit requisitions to DOD's supply systems, or by buying authorized GFM items from commercial sources and be subsequently reimbursed by the Navy.

Federal and Defense Acquisition Regulations authorize GFM to be provided to contractors when it is determined to be in the best interest of the government for reasons of economy, standardization, production expediency, and other appropriate circumstances. The regulations state, however, that maximum reliance is to be placed on contractors to provide all material necessary to accomplish government contracts. The Federal Acquisition Regulations (FAR) and DOD instructions require that decisions to provide GFM be justified in writing.

The FAR and individual contract provisions specify contractor and government responsibilities for controlling, protecting, preserving, maintaining, and accounting for GFM. To satisfy these requirements, contractors are to establish and maintain property control systems, which are subject to review and approval by the government's property administrators. Property administrators are to perform annual surveys of the contractor's property control system covering 10 categories, such as acquisition, use, consumption, receiving, and record-keeping.

Since contractors generally maintain the government's official accountable records for GFM in their possession, the contractors' property control systems need to accurately account for this material.

³For purposes of this report, the government supply system includes materials managed by the military services, Defense Logistics Agency, and General Services Administration. For example, within the Navy, the system includes wholesale activities—inventory control points, such as the Aviation Supply Office and Ships Parts Control Center, and Navy supply centers—and retail activities, such as Navy ships and base supply organizations.

Previously Reported Weaknesses in Managing GFM

During the 1970s and 1980s, GAO, DOD, and Navy audits have identified significant weaknesses in the management and control of GFM by DOD and the Navy. Some of the weaknesses reported since 1976 follow:

- In 1976, a Defense Supply Agency audit (now Defense Logistics Agency) of the adequacy of DOD and contractor controls over GFM at 66 selected contractors concluded that (1) contractors' handling of GFM needed improvement, (2) government surveillance of contractors' property control systems was inadequate, and (3) government property administrators did not receive sufficient guidance to effectively review contractor property control systems. The report also identified numerous contractor deficiencies, including the use of GFM on commercial contracts, excessive use of high priority designators to requisition and transport materials for contract performance, acquisition of GFM in excess of contractual needs, and GFM not reflected on contractor stock records.⁴
- In 1978, the Defense Audit Service (now part of DOD's Office of the Inspector General) reported that long-standing deficiencies continued in (1) the acquisition and use of GFM by contractors and (2) the government's oversight of GFM. The report concluded that in view of these long-standing deficiencies, DOD should limit contractors' access to the DOD supply system and require the contractors to buy the material.⁵
- From 1976-87, the Naval Audit Service issued at least 16 reports that identified the following deficiencies relating to GFM (1) contractors' property control systems were inadequate for a variety of reasons, including failure to provide for physical inventories; (2) government property administration responsibility was not properly assigned and the annual property system surveys were inadequate, incomplete, or not performed; and (3) GFM in excess of contract needs was found in the contractors' possession.

Table 1.1 shows the frequency and recurring nature of GFM weaknesses in the 16 reports.

⁴Audit of Government-Owned Material at Selected Overhaul and Maintenance Contractors (Report No. 77-40, Oct. 1976).

⁵Administration of Maintenance, Overhaul, and Repair Contracts (Report No. 890, May 1978).

**Chapter 1
Introduction**

Table 1.1: GFM Weaknesses Reported by the Naval Audit Service

Audit Report	Reported weaknesses		
	Contractor's property system	Inadequate property administration	Excess GFM
1. <u>Supervisor of Shipbuilding, Conversion and Repair, USN, Newport News Shipbuilding and Drydock Co., Newport News, Va. (Aug. 1976)</u>	•		
2. <u>Aviation Supply Office, Philadelphia, Pennsylvania, Supply Management (Oct. 1978)</u>			•
3. <u>Supervisor of Shipbuilding, Conversion and Repair, Pascogula, Miss. (Mar. 1979)</u>			
4. <u>Fleet Combat Direction Systems Support Activity, Dam Neck, Virginia Beach, Va. (July 1979)</u>	•	•	
5. <u>Multi-Location Audit of Aviation Supply Offices' Management of GFM (Nov. 1979)</u>			•
6. <u>Supervisor of Shipbuilding, Conversion and Repair, USN, Newport News, Va. (Apr. 1980)</u>	•	•	
7. <u>Naval Plant Representatives' Office, Lynn Mass. (Apr. 1980)</u>		•	
8. <u>Office of Naval Research, Western Regional Office, Pasadena, Calif. (Dec. 1981)</u>		•	
9. <u>Place I of the Interservice Audit of Government Furnished Material in the Possession of Contractors and Grantees (Aug. 1983)</u>	•		•
10. <u>Audit of Government Furnished Property in the Possession of Contractors and Grantees (Sept. 1983)</u>	•	•	
11. <u>A Review of Procurement, Property, and Other Selected Functions at the Supervisor of Shipbuilding, Conversion and Repair, USN, New Orleans, La. (June 1984)</u>		•	
12. <u>Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, Stratford, Conn. (May 1985)</u>	•	•	•
13. <u>Internal Controls, Contract Administration, Property Administration and Financial Management at Naval Plant Representative Office, Laurel, Md. (Mar. 1986)</u>		•	
14. <u>Addendum to: Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, St. Louis, Mo. (Aug. 1986)</u>			•
15. <u>Selected Aspects of Range Operations at the Pacific Missile Test Center, Pt. Mugu, Calif. (Sept. 1986)</u>		•	
16. <u>Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, Bethpage, N.Y. (June 1987)</u>			•

Also, in 1985, 1986, and 1987 reports to DOD under the Federal Managers' Financial Integrity Act of 1982,⁶ the Navy has recognized problems in the management of GFM.

Prior Congressional Interest

The lack of accountability and control over GFM was also the subject of a House Committee on Appropriations hearing on the fiscal year 1979 Defense appropriations request. The subsequent report (No. 95-1398), issued on July 27, 1978, questioned the practice of providing maintenance contractors with excessive authority to requisition GFM. The Committee requested that DOD test a concept that would allow contractors to use the DOD supply system but would require them to pay for materials requisitioned. DOD tested the concept and found that contractors were reluctant to participate due to the associated financial risk. The then Deputy Assistant Secretary of Defense for Logistics and Material Management recommended that some alternative means be used to control access to the DOD supply system.

In March 1981, DOD issued an instruction (DODI 4140.48) entitled "Control of Access to DOD Material Inventories by Maintenance Contractors," which directed each service to establish management control activities (MCA) to maintain control over maintenance contractors' access to the DOD supply system by ensuring that only authorized material was provided under the terms of the contract. To maintain this control, each MCA was to identify all maintenance contracts authorizing GFM and to validate and approve contractor requisitions prior to processing. The Navy's implementing instruction, the Naval Supply Systems Command Instruction 4440.169, with the same title as the DODI, was issued in May 1983.

The Subcommittee on Legislation and National Security, House Committee on Government Operations, held a hearing in March 1985 on government-furnished property provided to defense contractors. In its May 1985 report (No. 99-139) entitled Costly Failure to Control Government Property Furnished to Contractors Remains Uncorrected, the Subcommittee recommended, in part, that (1) DOD efforts to install appropriate accounting controls over government-furnished property be accelerated and (2) plans for implementing the MCA concepts contained in DODI

⁶The purpose of the act was to establish a system of internal accounting and administrative controls to provide reasonable assurance that (1) funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation; (2) revenues and expenditures are properly recorded and accounted for; and (3) obligations and costs comply with applicable law. The act requires DOD to report to the Congress annually on its internal control weaknesses. The annual reports are based on reports submitted by the services and Defense agencies.

4140.48 be expedited and the control requirements extended to production and supply contractors.

In March 1986, DODI 4140.48 was revised and extended to cover all types of contracts (for example, production, research, and development) for both base and centrally awarded contracts. DOD plans to implement the new instruction in phases, starting with maintenance and production contracts awarded at the wholesale level before going on to service contracts awarded at the retail level. In January 1988, the Navy was in the process of drafting and coordinating their implementing instruction.

Objectives, Scope, and Methodology

Our objectives were to evaluate the Navy's controls over GFM provided to its contractors. Specifically, we

- determined if the Navy had properly implemented the FAR and DOD policy requirements to justify and document decisions to provide contractors with GFM;
- evaluated the adequacy of Navy controls established to validate and approve contractor GFM requisitions; and
- assessed the adequacy of controls over GFM in the possession of contractors at the place of contract performance.

To determine if the Navy adequately justified and documented the need to provide contractors with GFM, we visited the Office of the Assistant Secretary of Navy (Shipbuilding and Logistics), four major commands, one Navy program office, the Aviation Supply Office, and one Naval Regional Contracting Center. At these locations, which were judgmentally selected, we obtained the policies on providing GFM, the contractual authorization terms, and the value of GFM provided. We discussed with responsible officials their rationale for providing GFM and evaluated written GFM justifications for selected contracts to the extent they were available.

To determine if the Navy reviews and approves requisitions for GFM, we visited the Navy Accounting and Finance Center, the Aviation Supply Office, the Ships Parts Control Center, one Naval Plant Representative Office, the Strategic Weapons Facility Pacific, one naval air station, and one naval base. At these locations, which were judgmentally selected, we reviewed the Navy's procedures and, in some instances, tested the application of GFM procedures.

To assess the controls over GFM provided to contractors, we visited the Aviation Supply Office, one naval regional contracting center, the Strategic Weapons Facility Pacific, one Naval Plant Representative's Office, one Air Force Plant Representative's Office, one naval air station, one naval base, and six judgmentally selected contractors. At the contractors, we documented the internal control weaknesses identified in the government property administrators' annual system survey reports and determined whether 4 of 6 ongoing contracts included potential excess GFM. Also, we obtained information on the Navy's property accounting system.

We focused on two maintenance contracts, three service contracts, and one multi-type maintenance, production, and service contract. We discussed matters pertaining to the contracts that we reviewed with some contractor officials. We did not include production contracts because of ongoing Naval Audit Service work in this area.

We conducted our review between April 1986 and January 1988 at the following Defense locations:

Department of the Navy

- Office of the Assistant Secretary of the Navy (Shipbuilding and Logistics), Washington, D.C.;
- Navy Accounting and Finance Center/Assistant Comptroller, Financial Management Systems, Washington, D.C.;
- Naval Audit Service, Washington, D.C.;
- Naval Air Systems Command, Washington, D.C.;
- Naval Facilities Engineering Command, Washington, D.C.;
- Naval Sea Systems Command, Washington, D.C.;
- Naval Supply Systems Command, Washington, D.C.;
- Strategic Systems Program Office, Washington, D.C.;
- Aviation Supply Office, Philadelphia, Pennsylvania;
- Pacific Missile Test Center, Naval Air Station, Point Mugu, California;
- Naval Plant Representative Office (NAVPRO), Stratford, Connecticut;
- Naval Regional Contracting Center, Long Beach, California;
- Ships Parts Control Center, Mechanicsburg, Pennsylvania;
- Strategic Weapons Facility Pacific, Bremerton, Washington;
- Naval Air Station, Point Mugu, California; and
- Naval Submarine Base Bangor, Bremerton, Washington.

Department of the Air Force

- Air Force Plant Representative Office at Hughes Aircraft Company, El Segundo/Long Beach, California.

Table 1.2 lists the six contractors, the location where contract work was performed, the contracts reviewed, and the GFM inventory balances associated with each contract.

Table 1.2: Contractors/Contracts Selected for Review

Contractor	Contract reviewed	GFM inventory balance	
		As of	Amounts
Computer Sciences Corporation Point Mugu, Calif.	NOO123-87-C-0383	1/87	\$2.5
Hughes Aircraft Company El Segundo/Long Beach, Calif.	NOO383-87-G-7829	1/87	12.2
Lockheed Missile and Space Co, Inc. Naval Submarine Base Bangor Bremerton, Wa.	NOO030-86-C-0087		0 ^a
Pan Am World Services, Inc. Naval Submarine Base Bangor Bremerton, Wa.	N62474-81-C-8831		0 ^a
RCA Service Company Point Mugu, Calif.	NOO123-87-C-0391	4/87	1.0
Sikorsky Aircraft Division Shelton, Conn.	NOO383-86-G-6893	10/86	17.7

^aThe Navy, not the contractors, maintained the official government property records at these locations. Contractors requisition the material only when needed for actual use.

We tested for potential excess GFM at two contractors by using the sampling procedures set forth in section S3-402.8, Armed Services Procurement Regulation, supplement 3, and projected the test results on a 95-percent confidence level. For two other contractors, we computed the excesses based on contractor-reported information on material usage and stockage levels.

We have issued separate reports on the Army and Air Force controls over and accountability for GFM.⁷

Our review was conducted in accordance with generally accepted government auditing standards.

⁷Internal Controls: Status of Army Efforts to Control Contractor Access to the DOD Supply System (GAO/NSIAD-88-98, Mar. 11, 1988); and Internal Controls: Air Force Can Improve Controls Over Contractor Access to DOD Supply System (GAO/NSIAD-88-99, Mar. 18, 1988).

Navy GFM Authorization and Requisitioning Control Procedures Are Ineffective

Navy controls over contractors' access to the DOD supply system are exercised through contractual GFM provisions and Navy review, validation, and approval of contractors' requisitions. The Navy has not effectively controlled contractors' access to DOD's supply system because (1) it has authorized and provided GFM, including readily available commercial items, without adequate evaluation and written justification and (2) it does not have the management and control systems required by DOD to adequately control GFM requisitions.

GFM Policy

The FAR and DOD, and Navy regulations require that contractors provide the material necessary to accomplish their contracts, except when it is determined to be in the best interest of the government for reasons of economy, standardization, production expediency, and other appropriate circumstances. If, for example, the Navy had an oversupply of a particular item needed for contract performance, it would likely be prudent to provide the item as GFM rather than have the contractor purchase an identical item and include his costs in the contract price. Similarly, if the supply system has an item that is military-unique or not readily available from commercial sources, the Navy would furnish the item as GFM.

DODI 4140.48, DODI 4100.33 (Commercial Activities Program), and the Naval Supply Systems Command Instruction 4440.169 state that exceptions to the basic FAR policy requiring contractors to provide all material necessary to accomplish their contracts to be supported by sound rationale and be documented in writing.

Lack of Compliance With Policy

The Navy activities we visited generally did not comply with the policy requiring that the decisions to provide material be based on sound rationale and be documented in writing.

We reviewed eight randomly selected maintenance contracts awarded by the Navy's Aviation Supply Office that relate to repair and modification of aircraft components and assemblies. In all eight we found that the Navy had provided the GFM to the contractors but had not prepared the required detailed analyses or written documentation. The policy was not being followed because ASO inventory managers told us that ASO's procedure, in recent years, was to provide contractors with the materials necessary for contract performance. Their reasons for following this procedure included the following:

- Government parts, ordered in large quantities, are less expensive than contractor purchases in small quantities.
- Contractors are reluctant to purchase materials that may not be used during contract performance.
- Contractors can accomplish maintenance and repair in a shorter period of time when material is furnished.

These reasons for providing GFM may be valid in specific contracting situations. However, we found no evidence of any Navy analysis showing that they applied to the specific contracts we reviewed. In December 1987, ASO officials stated that they were attempting to maximize the repair parts contractors will furnish as materials on new contracts.

We also found that the Navy provided material for production, research and development, and service contracts, but had not prepared the required detailed analyses or written documentation. We reviewed the basis for providing GFM to three contractors located at Point Mugu Naval Air Station and Naval Submarine Base Bangor and found that the decision to provide GFM was not documented as required by DODI 4100.33. These contractors were provided GFM and authorized to purchase commercially available items under the terms of their contracts when GFM was not available from the supply system. For example:

- Contract terms with Computer Sciences Corporation, which performs test range support at Point Mugu, authorized the contractor to obtain all materials, such as office and other miscellaneous supplies, as GFM. The contract also authorized the contractor to purchase such materials from commercial sources when operational requirements precluded obtaining the material from government sources and when government material was not readily available. During the 18-month period ending March 1987, the contractor obtained \$1.1 million in GFM through base supply and purchased additional materials, including office supplies, worth \$0.7 million from commercial sources.
- Contract terms for Lockheed Company, which performed Trident missile production, maintenance, and other related services at the Submarine Base Bangor, authorized the contractor to obtain all materials necessary for contract performance as GFM, except certain categories of items such as (1) hand tools and accessories, (2) office supplies, (3) gas, oil, and lubricants, and (4) personal clothing and safety items. Lockheed obtained about \$500,000 of GFM during fiscal year 1986 from the Navy's Strategic Weapons Facility Pacific. The items obtained by Lockheed

included such readily available commercial items as typewriter paper, plastic bags, and varnish brushes.¹

Without a written justification it is difficult to determine whether the decision to authorize some materials, such as office supplies, as GFM was in the best interest of the government. Furthermore, the fact that the material was available from commercial sources indicates that the Navy should have used sound rationale and documented its decision before authorizing the material as GFM.

Navy Has Not Implemented the Management Control Activities Required by DOD

The Navy does not have the management and control systems required by DOD to adequately control GFM provided to contractors. DOD policy requires the services to establish MCAs to control government-furnished material requisitions on all contracts. DOD issued instructions in 1981 that required the services to establish MCAs to control government-furnished material provided to maintenance contractors, and it had expected implementation by November 1982. In March 1986, DOD issued revised instructions, expanding the scope of the instruction to include all contracts for such areas as production, research and development, and service.

Navy's Control Over Maintenance Contracts

In March 1981, DOD issued an instruction, DODI 4140.48, entitled "Control of Access to DOD Material Inventories by Maintenance Contractors." The instruction applied only to GFM provided to maintenance contractors, and DOD expected the controls to be in place by November 1982. Specifically, the instruction requires DOD components to establish one or more automated internal control mechanisms, called management control activities. The MCAs are to

- validate and approve all maintenance contractor requisitions;
- reject all requisitions that do not comply with contract terms;
- pass approved requisitions to appropriate DOD supply sources for action;
- maintain a contract, requisition, and shipment status history file that serves as an auditable record of GFM transactions; and
- provide DOD contract administration offices with a semiannual report of GFM shipments to contractors and the number of requisitions rejected.

¹In comments on our draft report, the contractor stated that some of the brushes and plastic bags were military specified items.

In May 1983, the Navy issued an implementing instruction for establishing MCAs for maintenance contracts. The instruction required that MCAs be established at its ASO, Philadelphia, Pennsylvania, for aviation materials; and Ships Parts Control Center, Mechanicsburg, Pennsylvania, for nonaviation material.

Aviation Supply Office

As of January 1988, the Supply Office had not yet fully implemented an MCA. At the time of our review, the ASO served 117 maintenance contracts. The specific value of GFM provided in support of these contracts was unknown.² The MCA manually controlled 37 contracts but did not control the remaining 80 contracts. For the 37 MCA-controlled contracts, the responsibilities assigned to the MCA were similar to those outlined in the DOD instruction.

We did not test how effectively the MCA carried out its responsibilities, because at the time of our review, the ASO was in the process of automating its management control function.

For the contracts not covered by the MCA, the Navy's review and approval procedures for GFM requisitions varied. A brief description of the procedures used in two contracts follows.

- Hughes Aircraft Company, which was performing a Navy aviation maintenance contract at its El Segundo and Long Beach, California, facilities, prepared and submitted quarterly GFM requirement listings to ASO inventory managers. The inventory managers reviewed the listings, annotated their recommendations, and returned them to Hughes. The company then prepared and submitted the GFM requisitions to the DOD supply system. The government's property administrator validates the contractor's GFM requisitions during annual surveys. He did not report any discrepancies in the fiscal year 1986 annual survey report.
- Sikorsky Aircraft Division, which was performing a contract for overhaul and repair of helicopter components at its Shelton, Connecticut, facilities, prepared GFM requisitions, verified that each item requisitioned was authorized by the contract, and forwarded the GFM requisitions to the cognizant Naval Plant Representative Office (NAVPRO). Without any internal review, NAVPRO submitted the government-furnished material requisitions into the DOD supply system. NAVPRO officials

²The ASO estimated that it had provided about \$133 million of GFM to its contractors between October 1985 and August 1986. The ASO does not collect information on the value of GFM provided on each individual contract.

told us that they did not have the personnel to perform review of the large volume of requisitions processed. We found that Sikorsky's procedures for determining GFM quantities resulted in Sikorsky ordering larger quantities than needed, which contributed to the contractor having excess GFM. (See ch. 3.) NAVPRO and contractor officials agreed that they had ordered more GFM than was needed.

The ASO has begun developing a new MCA system. The Navy stated that because of the volume of requisitions, there was a need to automate the Supply Office's MCA system. A project to automate the ASO management control activity, called the Contractor Aviation Material Management System, was started in January 1987. The system will cover maintenance and production contracts. It will validate material requirements, generate requisitions, and generate the purchase request if material is not available from the DOD supply system. The ASO projects the system to be fully operational by December 1989. The development of the system has not progressed far enough for us to test its effectiveness.

Ships Parts Control Center

The Ships Parts Control Center had not established an MCA as required by DOD and Navy instructions for its maintenance contracts. The Center's policy was to have contractors provide the material, except when it was considered to be in the government's best interest to provide GFM. According to the Navy 1983 instruction, the Control Center should have established an MCA because it provided government-furnished material to some maintenance contractors. Center officials stated that they had not established an MCA because they provided little GFM in response to contractor requisitions.

If the January 1988 Navy draft instruction discussed below is implemented, GFM requisitions filled by the Center will have to be reviewed and approved by an MCA.

Navy's Controls Over Nonmaintenance Contracts

The March 1986 revised DOD instruction expanded its scope to include the screening of GFM requisitions by MCAs for all types of contracts in such areas as production, research and development, and service. DOD expected the services to implement the revised instruction in phases, starting with research and development and production contracts and ending with service contracts performed on military installations.

In January 1988, the Navy prepared a draft instruction based on the 1986 DOD instruction. This draft instruction, if properly implemented, will go a long way toward standardizing existing GFM requisition review and approval procedures for all contracts, which our review showed are currently not in place. Procedures at two contractors are described below.

- Computer Sciences Corporation, which was performing a test range support contract at the Navy's Missile Test Center, Point Mugu, California, was permitted to prepare and submit requisitions for GFM valued at less than \$5,000 directly to base supply at Point Mugu without any review by the Test Center. For GFM requisitions with a higher value, the contractor was required to prepare and submit requisitions to the Center for approval. For approved requisitions over \$5,000, the Center returned items to the contractor for submission to Point Mugu base supply.

For the 18-month period ending March 1987, the contractor received about \$1.1 million of GFM. Of 26 requisitions we judgmentally selected for review, 4 exceeded \$5,000. For 2 of the 4, the Center's approval had not been obtained. Center officials told us that they plan to establish procedures requiring review and approval of all contractor GFM requisitions. In its response to our draft report, the contractor stated this procedure has been established.

- Pan Am World Services, Inc., which was performing a service contract at the Navy Submarine Base Bangor, prepared, approved, and submitted requisitions directly to base supply. These requisitions were subjected to an "after-the-fact review" by the base property administrator. The property administrator found that Pan Am was only requisitioning the materials necessary for each project under the contractually approved tasks.

Management, Accountability, and Financial Controls Over Material Provided to Contractors Are Inadequate

Effective management, accountability, and financial controls over GFM have not been adequately maintained by the Navy and its contractors as required by government and DOD policies. We found that the Navy and its contractors were unable to account for and did not properly control GFM. These conditions have been reported over several years without major improvements in these areas.

Our work and recent Naval Audit Service reports identified potential excess GFM at contractor locations. We found over \$18 million of potential excess GFM under four contracts, and the Naval Audit Service identified an additional \$268 million of potential excess GFM at two contractor locations. Also, we and the Naval Audit Service disclosed deficiencies in contractor property control systems and in the government's oversight of the systems. As a result, the Navy did not have visibility over millions of dollars of GFM in the possession of contractors. Therefore, Navy inventory managers could not redistribute unneeded GFM at contractors' plants to meet other, possibly higher priority, requirements elsewhere.

In addition, since 1967 we—as well as congressional committees—have recommended that DOD and the services establish adequate property accountability and financial controls over GFM. The Navy has made some progress to improve property accountability, but much more needs to be done in the areas of contract and property administration. In the area of financial controls, the Navy has yet to establish an accounting system that would meet DOD's requirements.

Navy reports on internal control weaknesses, which are required under the Federal Managers' Financial Integrity Act, did identify some of these weaknesses over GFM.

Potential Excess Material Provided to Contractors

Contractors are required to promptly report government-furnished materials to the government that is excess to their needs for contract performance. Also, DOD policy requires property administrators to ensure that contractors promptly report excess GFM. The Naval Audit Service and various contractors have defined potential material excesses as occurring when (1) no material is used during a 12-month period or (2) the on-hand material balances exceed material use for a 12-month period.

Our work and recent Naval Audit Service reviews identified significant potential excess GFM in the possession of Navy contractors that had not

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been reported as excess. Using the Naval Audit Service and various contractor criteria, we identified about \$18.6 million of potential excess GFM under four contracts involving four contractors.

Table 3.1: Potential Excess GFM

Dollars in millions	
Contractor	Dollar value of potential excess GFM
Hughes Aircraft Company, El Segundo/Long Beach, Calif.	\$8.5
Sikorsky Aircraft Division, Shelton, Conn.	7.1
Computer Sciences Corporation, Point Mugu, Calif.	2.4
RCA Service Company, Point Mugu, Calif.	0.6
	\$18.6

A discussion of the causes for the potential excesses and the companies actions to reduce the excesses follows.

- At Hughes Aircraft, company officials told us that most of the \$8.5 million of potential excess material resulted from (1) Navy transfers of material to Hughes when it first assumed contract operations and (2) Navy transfers of material from prior contracts without determining whether the material was needed on the current contract.

Subsequent to our review, Hughes officials advised us that they reviewed the GFM inventory pertaining to the contract for excesses. They determined that at least \$5.8 million was excess to contract needs and they requested disposition instructions from the ASO for it. They also told us that a review of outstanding requisitions for the contract resulted in cancellation of \$4.3 million of material.

- At Sikorsky Aircraft Division, where the potential excess material amounted to \$7.1 million, we determined that Sikorsky requisitioned excessive GFM quantities when it considered the inventory balances, prior years usage, and their forecasted GFM requirements. Navy and contractor officials agreed that there was potential excess GFM and that more GFM was ordered than was needed. The Navy and the contractor are now determining the exact amount of excess GFM and what to do with it.
- At Computer Sciences Corporation, contractor officials told us that the \$2.4 million of potential excess material was caused by (1) Navy transfers of material to them when they first assumed contract operations, (2) the need for them to maintain some material as insurance against unforeseen circumstances, and (3) Navy requirements for maintaining a

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certain amount of stock on hand. We found that some of the Navy stock requirements exceeded the contractor's 12-month material usage.

In its response to our draft report, the contractor further elaborated on the reasons for retaining the \$2.4 million of potential excess material. The contractor stated that \$0.65 million of the \$2.4 million was considered to be insurance items by them and \$1.3 million was for spares required by the Navy's Trident program. The remainder, \$0.45 million, was retained for other reasons. The contractor acknowledged that the documentation for the \$0.65 million was inadequate to make an accurate assessment of the actual excess.

- At RCA Service Company, we determined that the \$0.6 million of potential excess occurred because the contractor maintained more stock on hand than it used during a 12-month period. For example, in one case, RCA had 25 nose cones for aerial targets in stock, but only 3 were used during a prior 12-month period. According to Navy officials, other factors contributing to the potential excess were similar to those discussed in the Computer Sciences Corporation example. They added that the Navy plans to review the potential excesses we identified.

In its response to our draft report, the contractor stated that much of the potential excess material was associated with items needed to protect against extended delays in procurement of these items (long lead time items). Also, salvage of usable components from damaged targets could have contributed to the potential excess. Regarding our nose cone example, the contractor stated that the number of nose cones in stock consisted of five different types and a small supply of each had to be kept on hand to support specific mission requirements. The contractor also stated that usage data for the cones were only maintained to document complete replacement of nonrepairable nose cones and did not consider refurbished nose cones that were subsequently used. As a result of our work, the contractor revised his stock records to more accurately reflect the actual conditions.

The Naval Audit Service also reported substantial amounts of GFM excess to production and maintenance contractor needs.

- A June 1987 report noted that the contractor (Grumman Aerospace Corporation) retained about \$114.5 million of material from completed contracts and held an additional \$7.1 million in material for which there

had been no demand for a 12-month period.¹ The report concluded that, as a result, the government (1) may have been unnecessarily charged for storage costs and (2) may have acquired up to \$121 million in unneeded material. The responsible Navy command agreed that of the \$114.5 million, \$36.7 million represented potential excess. The command claimed that the remainder was required by the contractor. The Naval Audit Service disagreed and requested that the Chief of Naval Operations review this matter. The Navy command agreed that the additional \$7.1 million was excess and requested disposition instructions.

- An August 1986 report noted that the contractor (McDonnell Douglas Corporation) retained about \$126 million of government property in support of aircraft programs that did not have any demand during a 12-month period.² The report cited an additional \$20 million of excess government property that supported the contractor's missile program. The report concluded that about \$50 million in potential savings might be realized by redistributing or disposing of GFM inventories that appeared to be excess to requirements. The responsible Navy command concurred with the results and had (1) transferred \$30 million of the excess inventory to other users, (2) disposed of \$5 million because it was obsolete, and (3) agreed to review the remaining excesses to determine the benefits to be gained from redistribution and disposal.

Weaknesses in Contractor Controls Over GFM

The FAR, Navy regulations, and contract provisions prescribe that contractors be responsible for establishing and maintaining property control systems to account for, control, and safeguard GFM. Further, the contractors' property records constitute the government's only official records of GFM. The contractors' systems and records should at least identify all GFM in the contractors' possession, require periodic physical inventories of GFM, and maintain physical control and adequate safeguards to prevent the theft and loss of material.

Weaknesses in contractor controls over GFM have been reported by the Naval Audit Service since at least 1976. Our work disclosed that problems in this area continue. For four contractors who maintained the official government property records, prior Navy property administration surveys and our work identified a number of serious weaknesses in the

¹Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, Bethpage, New York (Report No. A20076, June 30, 1987).

²Addendum to: Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, St. Louis, Missouri (Report No. A20684L, Aug., 1986).

internal controls over GFM. For example:

- At the Sikorsky Aircraft Division plant, the Navy property administrator's annual property surveys for 1982-86 disclosed that the contractor (1) had no written procedures for conducting physical inventories, (2) had not taken annual GFM inventories, (3) was not adequately monitoring GFM under the control of subcontractors, (4) did not report all instances of GFM losses and damage, (5) had lost material when transferring between locations, and (6) was not recording property balances that differed significantly from the property administrator's physical inventory. In December 1986, the NAVPRO threatened the contractor with disapproval of his property control system. Sikorsky officials agreed that these problems were long-standing and said that they planned to take corrective actions.
- At the Computer Sciences Corporation, we found that the contractor's property records did not include over \$670,000 of GFM that was at a secondary location. In addition, the contractor removed a computer memory module valued at \$26,000 from stock without recording that it had been issued and later replaced with another module without recording its receipt. In the contractor's response to our draft report, it stated that the material at the secondary location has now been recorded in its property control records.
- At Point Mugu, Computer Sciences Corporation and RCA Corporation personnel told us that employees had removed GFM items from the stock inventories without recording their removal. Neither they nor we could determine the extent of this practice because no records had been made of the transactions.

In its response to our draft report, RCA stated that we had only observed one instance where GFM was removed without recording it on the records. However, the contractor acknowledged that potential for unrecorded GFM removal exists because his storage area is insufficient to properly control access to the GFM. Computer Sciences Corporation also admitted occasional unrecorded removal of GFM was a problem. The contractor also believed that a contributing factor was the lack of fully secured storage areas.

The Naval Audit Service disclosed similar contractor government-furnished material (GFM) as well as other government property control

problems. For example:

- A May 1985 report stated that a contractor with over \$303 million of government property, including \$36 million of GFM, operated with outdated and incomplete property control procedures.³ Some of the procedures, which had been approved in the early 1970s, had not been updated. The report concluded that, as a result, there was no assurance that the property was adequately controlled.
- A September 1983 report said that the property control system used by a contractor, which had about \$210 million of government property, was cited by the government's annual system surveys as deficient.⁴ The report explained that, although the contractor had instituted a new system to correct past deficiencies, the last inventory showed that 1,499 items valued at \$3.7 million could not be located and \$28.2 million of tooling and industrial plant equipment had never been inventoried.
- An August 1983 report stated that two contractors had been provided about \$1.1 billion of GFM under two contracts for the construction of aircraft carriers and submarines, but they had never performed physical inventories as required by the FAR.⁵ Government-furnished material provided for the carrier contract totaled \$736 million and for the submarine contract \$363 million.

Weaknesses in Government Property Administration

The FAR requires government property administrators to perform annual surveys of the contractor's property control system to ensure that the approved system is functioning as designed and that the contractor maintains adequate controls over government property. Our work showed that weaknesses remain in the government's oversight of GFM in the possession of contractors.

These annual surveys cover 10 categories ranging from acquisition, use, and consumption to receiving and record-keeping. Deficiencies noted during these surveys are to be reported to the contractor for prompt corrective actions. If the contractor fails to maintain an effective property control system, the contractor's system may be disapproved and

³Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, Stratford, Connecticut (Report No. A20664L, May 9, 1985).

⁴Audit of Government Furnished Property in the Possession of Contractors and Grantees Phase II (Report No. G20052, Sept. 29, 1983).

⁵Phase I of the Interservice Audit of Government Furnished Material in the Possession of Contractors and Grantees (Report No. C20052, Aug. 1, 1983).

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the contractor can be held financially liable for future losses of government property. General guidance to property administrators for performing the surveys is given in supplement 3 to the FAR.

Our review of property administrators' annual survey reports showed that surveys were not always performed annually, corrective actions on deficiencies were not always taken, and internal control weaknesses were not reported by the property administrators. Examples of inadequate government oversight for GFM follow.

- As discussed earlier, the property administrator's 1982-86 annual surveys at the Sikorsky Aircraft Division plant disclosed a number of serious deficiencies, including some that were recurring, in the contractor's property control system. The contractor agreed to take corrective actions on the deficiencies when the NAVPRO threatened the contractor in December 1986 with disapproval of its property control system.
- The property administrator's 1984 and 1985 surveys at Computer Sciences Corporation reported that the contractor was using higher than authorized priority designators to requisition GFM.⁶ This situation still existed during our review. We found that on 25 of 26 randomly selected requisitions, the contractor cited higher priority designators than authorized by Navy regulations. At RCA Service Company, we also found that the Navy had inserted higher priority designators than authorized on 12 of 15 randomly selected GFM requisitions. The property administrator had not reported this matter in his annual survey reports. A Navy official told us that the Navy had used the higher priority designator to help RCA more effectively compete for materials against other organizations and reduce back-order delays.
- At the Computer Sciences Corporation, we noted that the contractor's property records did not include over \$670,000 of GFM; this figure was not included in the annual inventory total. The government was not aware of this omission. This situation was not detected because there was no government property administrator assigned during fiscal year 1986; in fiscal year 1987, the property administrator told us he had not been given the authority to review the contractor's operations. Contractor personnel told us that the GFM was removed from their property control records when issued. However, they agreed that they should have accounted for the material until it was actually used. In response to our

⁶Priority designators are assigned to requisitions on the basis of criticality of needs, ranging from work stoppage to routine stock replenishment. The priority of the requisition determines the priority placed on filling the requisition and the mode of transportation. According to a Defense Logistics Agency report, the use of high priority designators often results in premium pay to personnel filling the requisition and in premium transportation costs.

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draft report, the contractor stated that the company has now recorded the GFM in the property control records.

The Naval Audit Service has reported similar problems since 1976. The following are examples of weaknesses noted in three recent reports:

- A June 1987 report said that property administration was not performed or insufficiently performed to adequately evaluate the contractor's (Grumman) property system, which controlled \$3.4 billion of government-furnished property located in 5 states and at about 400 sub-contractors.⁷ This deficiency was attributed to an insufficient number of government personnel assigned to property administration.
- A September 1986 report cited deficiencies in the Navy's oversight of \$41.3 million in government-furnished property provided to its contractors at the Navy's Pacific Missile Range Facility, Kekaha, Kauai, Hawaii.⁸ The report said that (1) the last annual property survey was performed in 1984 and (2) the survey documentation was a brief narrative that did not include information necessary to support the conclusions reached concerning the adequacy of the contractor's controls. The report concluded that these conditions existed primarily because a full-time property administrator had not been assigned to the contract.
- A March 1986 report cited inadequate Navy oversight of a contractor (Johns Hopkins University/Applied Physics Laboratory) that had \$138 million of government property at the university and at several remote locations.⁹ The report included the following two problems: (1) property surveys were not performed at six remote locations that had about \$4.7 million of government property, and (2) documentation was not available to support the Navy's approval of the contractor's property control system. One of the reasons cited for not surveying the remote locations was the lack of property administration personnel.

We have also found similar personnel shortages at the Naval Regional Contract Center, Long Beach, California. The Center, which awards all types of contracts for the western part of the United States, did not have any property administrators and needed to rely on the military installations to provide property administration. Of the 120 military

⁷Contract Administration, Procurement, and Other Selected Functions at the Naval Plant Representative Office, Bethpage, New York (Report No. A20076, June 30, 1987).

⁸Selected Aspects of Range Operations at the Pacific Missile Test Center, Point Mugu, California (Report No. C14506, Sept. 29, 1986).

⁹Internal Controls, Contract Administration, Property Administration and Financial Management at Naval Plant Representative Office, Laurel, Maryland (Report No. A30145, Mar. 20, 1986).

installations the Center served, only Point Mugu had a property administrator.

Accountability and Financial Controls

Since 1967, we—as well as congressional committees—have criticized DOD and the services for not having established property accountability and financial accounting controls over GFM. We have previously recommended that DOD and the services establish accounting systems that adequately account for (1) the quantity and value of government material authorized and provided to contractors and (2) the receipt and use of this material by contractors.¹⁰ As a result, DOD took action in two areas—property accountability and financial accounting. The Navy has made some progress and is continuing to improve in the property accountability area. However, DOD is awaiting the Navy's plans in the financial accounting area.

In the property accountability area, DOD established a database system in August 1986 called the "Department of Defense Industrial Property Management System." This system is to provide managers with sufficient visibility to adequately manage government-owned assets that are under their responsibility. Specifically, using contractor reports generated from the property records, the system tracks the beginning and ending fiscal year on-hand balances of all DOD property on a contract-by-contract basis. The balances are expressed in terms of quantity (except for government material) and dollar value. DOD has completed its data collection effort for fiscal year 1986 and already reported the result. It is now working on fiscal year 1987 data.

Although the actions taken by DOD in the property accountability area are steps in the right direction, we are concerned about the accuracy and completeness of the data reported. Our review of the 1986 DOD property report disclosed that it was incomplete, because not all contractors with property had submitted the required data. For example, three Navy contractors we reviewed, who had about \$21.2 million of GFM under three contracts, had not reported the necessary data. Another Navy contractor who had reported the data did not include two contracts with material valued at about \$22.5 million in his data submission. The same contractor also did not include GFM values for over 56,500 line items out of a total of over 65,700 line items on 4 other contracts. The value of the

¹⁰Need for Improvements in Controls Over Government-Owned Property in Contractors' Plants (B-140389, Nov. 1967); and Weaknesses in Accounting for Government-Furnished Materials at Defense Contractors' Plants Lead to Excesses (FGMSD-80-67, Aug. 1980).

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remaining 9,200 line items was about \$59.6 million. In addition, a 1987 Naval Audit Service report disclosed that a contractor had overstated the GFM value on his records by \$1.5 billion. The Audit Service also pointed out that it could not account for an additional \$900 million of government property recorded in the contractor's property system.

The contractor reports do not contain data dealing with the amount of government material added (acquired) and deleted (used, returned, or disposed of) during each fiscal year. DOD officials informed us that they decided not to include the additions and deletions because they believed the collection of such data would not be cost-effective.

We believe that information on the value of additions and deletions is desirable for several reasons. First, managers at various levels need to know the amounts of material that have been provided, used, or disposed of under each contract, for each command, or for each service. Second, the information can be used to identify contracts with potential excess material by relating on-hand balances to additions or deletions. Third, the information would give details on material provided on contracts where work has been completed. Also, the value of the material added or deleted could be significant compared to the value of the inventory maintained. For example, Lockheed obtained over \$600,000 in GFM during an 18-month period (October 1985 through December 1986) but had a zero-inventory balance. On the other hand, the RCA Service Company obtained about \$500,000 in GFM during fiscal year 1986 and had an inventory balance of \$1 million.

Navy officials stated that in order for the property accountability system to work effectively, improvements in contractual terms and property administration would be required. Some improvements that these officials believe are necessary include

- requiring major commands to incorporate annual property reporting clauses in contracts;
- prescribing an accounting method for pricing the GFM inventory;
- approving or disapproving the contractor's property system by the government's contract administration office;
- independently verifying contractor's records by the government's contract administration office, which would include, tracing and verifying receipts, issues, transfers, and disposals of GFM, and verifying that GFM was actually used on the appropriate contract; and
- obtaining contractors' annual property reports by the Navy from other DOD departments and agencies in a timely manner.

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The Navy has started making improvements in the property accountability area. For example, the Navy has developed, tested, and started implementing a procedure at two contractor locations to determine if the contractors' property records accurately reflect the shipments of GFM from other contractors and DOD wholesale supply activities. This verification is based on shipment listings and documents obtained from sources other than the contractor whose records are being verified. We believe these procedures (1) provide the government contract administrators the techniques to verify receipts and (2) strengthen internal controls because the information used for the verification is provided by external sources.

In the financial accounting area, DOD published its accounting manual DOD 7220.9-M in October 1983. This established financial property accounting principles to be implemented by the services in their accounting systems. The manual includes a general ledger control account for GFM. Entries in the account are to be made when the government ships or otherwise furnishes material to contractors, and when the contractor delivers or returns the product to or disposes of the material for the government.

According to the March 1985 testimony before the House Committee on Government Operations and other information obtained, a DOD official stated the Navy would have a fully implemented financial property accounting system for GFM by 1989. However, as of April 1988, the Navy had not submitted its GFM financial accounting plan to DOD for review and approval.

Navy's Reporting of GFM Management Problems

In the Navy's 1985, 1986, and 1987 reports to DOD on how it has met the objectives of the Federal Managers' Financial Integrity Act of 1982, certain GFM internal control weaknesses were noted. Specifically, the reports stated that there was a lack of monitoring and control over GFM at Navy contractor plants and that financial accounting of material inventories in the possession of Navy contractors was inadequate. The 1987 report estimated that corrective actions would continue through August 1988.

Conclusions and Recommendations

The Navy has had long-standing problems with accounting for and controlling GFM provided to contractors. Although actions have been taken to correct the situation, a number of significant problems remain and offer the potential for fraud, waste, and abuse.

Management control weaknesses pertaining to authorizing, issuing, and monitoring GFM continue to occur because the Navy has not fully implemented DOD government-furnished equipment policies or complied with its own policies. Although regulations have been in force since the early 1980s, the Navy has only recently drafted an instruction requiring that (1) decisions to provide GFM be based on sound rationale and be documented and (2) systems be established and that management control activities (MCA) be designated to review and approve GFM requisitions for contracts. Also, DOD or Navy GFM policies are not being complied with in that

- Navy organizations are not documenting the decisions to authorize GFM under maintenance contracts,
- the Navy has made little progress in establishing fully operational MCAs for maintenance contracts and has not yet established a target date for implementing MCA controls on its other contracts,
- Navy contractors did not have effective property control systems and were not promptly reporting excess GFM, as required by the FAR, and
- government property administrators' oversight of Navy contractors' property control systems was inadequate and did not assure that potential excess GFM was reported by contractors. A contributing factor to the government's inadequate oversight over GFM was a shortage of personnel assigned to property administration.

The Navy has taken some steps to improve property accountability over GFM. However, much more needs to be done in the area of contract and property administration for the property accountability system to work effectively. In the area of financial accounting for GFM, the Navy has not yet met DOD's accounting manual requirements.

In the Navy's 1985, 1986, and 1987 annual Federal Managers' Financial Integrity Act reports, the controls over GFM were cited as a material weakness. The 1987 report estimated that corrective actions would continue through August 1988. Although the corrective actions primarily concern the issuance of policy and manuals, our review found that the major weakness in the GFM area is primarily a matter of policy implementation. Therefore, the inadequate control of GFM should be reported

as a material weakness until the Navy assures itself that GFM policies have been properly implemented.

Recommendations

We recommend that the Secretary of the Navy

- require that decisions to allow contractors to obtain GFM are justified in advance, in writing, and are adequately documented to demonstrate that they are in the government's best interest from a cost-effective or other critical standpoint, as required by the FAR, DOD, and Navy regulations;
- ensure that Navy contractors and organizations fully comply with and enforce the FAR and DOD and Navy policies on authorizing, issuing, and overseeing government-furnished material. To ensure that this is done, monitoring may be required until it is evident that the long-standing problems in controlling GFM have been corrected;
- identify and make available, as appropriate, the additional resources needed for effective property administration;
- further improve property accountability for government material and develop and implement a financial accounting system that satisfies DOD's accounting manual requirements; and
- continue reporting the inadequate control of GFM as a material weakness in the Navy's annual Federal Managers' Financial Integrity Act report to DOD until corrective actions have been taken.

Agency Comments and Our Evaluation

DOD generally concurred with our findings and recommendations, and it outlined corrective actions for all recommendations without furnishing estimated completion dates.

DOD agreed that the Navy has not prepared the detailed analyses and written justifications required when GFM had been supplied. In response to our recommendation, DOD agreed that the Navy should reemphasize the requirement and monitor its implementation.

DOD agreed that the Navy has not yet fully implemented the MCA concept as envisioned by DOD. It concurred that the January 1988 Navy draft instruction implementing MCAs for all types of contracts will, if properly implemented, improve existing Navy GFM requisition review and approval procedures. DOD stated that publication of the draft instruction was a top priority. It also noted that subsequent implementation of the MCA concept at both the wholesale and retail levels is contingent upon

implementing an approved change to the Military Standard Requisitioning and Issue Procedures that institutes validation procedures on contractor requisitions on government material. The change is currently projected to be implemented in 1989.

DOD concurred that GFM management practices needed to be upgraded. DOD stated that there is a need to have greater visibility of GFM at contractor locations and to make the disposition of material assets, when no longer required for the contract, more timely. However, DOD did not agree with our use of the Naval Audit Service's and contractors' 12-month criteria for identifying potential excess material. DOD stated that other factors, such as the placement of material at contractor locations to prevent contract performance delays, are not considered in the criteria. DOD also believed that, in some instances, use of excess material on follow-on contracts may result in the most efficient use of the material.

We agree that a number of factors need to be considered when determining **actual** material excesses, since the use of excess material on follow-on contracts can be beneficial to the government in some instances. However, in order to determine **actual** material excesses, DOD and the contractors need a technique to identify **potential** excess material. In the Navy contracts reviewed, we found no technique or method that could accomplish this. Therefore, we used the 12-month criteria because we believed that it was reasonable for identifying **potential** excesses and that it did so in a conservative and practical manner. Also, the 12-month period coincides with the period specified by the FAR for the performance of government property surveys.

DOD agreed that there are continuing weaknesses in contractor property control systems and government property administration. In response to our recommendation, DOD reported that the Navy has

- initiated a FAR change that will require contractors to maintain their government property systems on an equivalent basis as systems used for their own property,
- started a project to review the government contract administration services, including property oversight, for contracts performed on military installations,
- started developing a course for those personnel assigned property administration responsibilities but lack the background or experience, and
- started an intern program to increase the professionalism of property administrators.

DOD agreed that the Navy has not yet developed the financial accounting for GFM as required by its accounting manual. The Office of the Secretary of Defense (Comptroller) and the Navy are working together to determine the most cost-effective methods for implementing the financial accounting requirements. DOD also stated that using contractor records as the official records of government-owned material was a sound and practical management policy. DOD voiced concern over the cost to the government of duplicating contractor records by the government without providing the government any additional information. Instead, DOD highlighted the Navy's program to verify contractor records using government-generated material requisition and issue data. DOD also noted that the integrity of contractor approved property central systems are verified by property system surveys conducted in accordance with DOD regulation.

We believe that the verification procedures, if properly implemented, are a step in the right direction. However, we are uncertain whether the Navy can rely on the government's annual property administration surveys to maintain the integrity of the contractors' property records and resultant reports. As illustrated in this report, there have been long-standing problems associated with both the contractors' property systems and the government's performance of property administration. Based on DOD's comments, we have clarified the property accountability and financial control areas discussed in this report, including the related recommendation.

DOD also acknowledged the existence of material weaknesses in the GFM area and agreed to continue reporting these material weaknesses in the Navy's Federal Managers' Financial Integrity Act annual statement to DOD until corrective actions have been taken.

We believe that the Navy actions are a step in the right direction and, if implemented properly and in a timely fashion, will alleviate the long-standing problems pertaining to the management controls, accountability, and financial accounting for GFM.

Contractors' Comments

The responses we received from three contractors concerned (1) clarification or additions to information presented in this report or (2) presentations of their actions. The responses were incorporated as appropriate.

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