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DEFENSE INVENTORY:

DOD's Efforts to Improve Management and Reduce Stocks Need to Continue

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss inventory management issues in the Department of Defense (DOD) and our conclusion that the amount for DOD secondary items in fiscal year 1993 should be at least $5 billion less than the amount appropriated in fiscal year 1992. Last week I appeared before the Senate Committee on Appropriations on this same matter. My testimony today will follow the same lines and also address additional areas in which you have expressed interest. We have been reporting on problems with DOD's inventory management for a long time. Over the last 20 years, we have issued more than 130 reports dealing with these problems. The problem areas we have examined include growth in the amount of unrequired inventory; weaknesses in the requirements determination processes; continuing to order material that is already excess to needs; and a lack of visibility over assets.

Although DOD has recently taken steps to improve inventory management, we see the problems to be of such magnitude that we have identified defense inventory management as 1 of 16 government activities that are highly vulnerable to mismanagement, fraud, and abuse.

DOD classifies its inventories as principal items (e.g. tanks, aircraft engines, ship components, and aircraft components) or secondary items. The secondary inventory consists of consumable

and repairable items. It includes parts for aircraft, missiles, weapons, tanks, vehicles, ships and submarines; electronic parts; construction supplies; petroleum, clothing; subsistence; and medical and dental supplies. These inventories are stored at major depots (wholesale level) and at installation warehouses (retail level). My testimony today deals primarily with secondary items.

GROWTH OF UNREQUIRED INVENTORY

Between 1980 and 1990, DOD's reported secondary item inventory grew from $43.4 billion to $101.9 billion[1]. Of the $101.9 billion, DOD reports that about $66.9 billion was supported by requirements; $29.5 billion was unrequired, and $5.5 billion was not distributed between the preceding two categories. DOD classified $8.1 billion of the $29.5 billion as "potential excess." This means that retention of the $8.1 billion cannot be justified for either defense or economic reasons. In March 1990, we issued three reports on growth in specific parts of DOD's inventory.

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[1]The amount of DOD's unrequired inventory has been widely reported as $35 billion. This was based on DOD's September 30, 1989 inventory report which showed that DOD had $109.5 billion of secondary item inventory, of which about $34.3 billion was reported as unrequired. DOD has since reported that, as of September 30, 1990, it had a secondary item inventory of $101.9 billion, of which about $30 billion was reported as unrequired. Most of the difference between the two inventory amounts, both total and unrequired, was due to a revaluation of inventory. GAO had recommended that DOD revalue its inventory and we do not disagree with the change; however, it should be recognized that most of the reduction is a valuation change and not an actual reduction.

-- DOD's inventory of aircraft parts grew from $17.3 billion in 1980 to $53.6 billion in 1988. The inventory of unrequired aircraft parts (inventory not supported by requirements[2]) increased at a faster rate than required stocks. The Air Force's required stock grew 179 percent and the unrequired stock grew 295 percent (from $2.0 billion to $7.9 billion). The most common causes for the growth were overestimated use rates and modifications of aircraft and equipment. Other contributing factors included faster than expected phase-out of older aircraft and decreasing war reserve and safety level requirements.

-- The Army's unrequired inventory grew by 168 percent between 1983 and 1988, compared to 96 percent for all inventories. The largest growth, in terms of dollars, of unrequired inventory was at the Aviation Systems Command, one of the six Army buying commands. Its unrequired inventory increased from $207 million in 1983 to $804 million in 1988. We found that the primary reasons the Command's unrequired inventory had increased were because (1) the Army continued to stock items for systems being phased out, (2) demands forecasted often did not materialize, and (3) the database that computed requirements contained erroneous data. We also found the Army was not reducing or canceling planned procurements when the items were not needed.

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[2]Requirements consist generally of war reserves plus 2 years of operating stocks.

-- The Navy's inventory of ship and submarine parts increased by 249 percent, from about $2.7 billion in 1980 to $9.3 billion in 1988. In 1988, 40 percent ($3.7 billion) of the Navy's inventory of ship and submarine parts was unrequired. We sampled the 183,000 items that include such stocks and found that the major causes for the unrequired inventory were requirements that did not materialize, deactivation of older ships, and replacement and phasing out of equipment.

We also found that some of the inventory that DOD characterizes as required does not really seem to meet the criteria for required inventory. Based on our analyses of September 1990 Navy and Air Force inventory reports, $10 billion, of the $39.6 billion inventory identified as required, exceeded the maximum amount needed to be on hand or on order, as defined by DOD instructions.

REQUIREMENTS DETERMINATIONS

In May 1991, we summarized 97 reports issued over the preceding 6 years by GAO and the defense audit agencies on DOD's inventory requirements determination processes. These reports contain many specific examples of problems with the requirements determination processes. These reports highlighted the following serious problem areas:

-- Inaccurate or unsupported data in the system caused misstated inventory requirements. For example, in August 1990, the Air Force Audit Agency reported that spare engine requirements were based on inaccurate engine removal rates, resulting in overstated engine requirements valued at $156.8 million.

-- Management personnel overrode computational models used to determine inventory requirements. For example, the Army Audit Agency reported in 1988 that one commodity command's failure to use accurate logistics data in computational models had led to the significant overstatement or understatement of resulting requirements.

-- There was inadequate consideration of an item's essentiality when ordering spare parts. For example, a May 1990 Air Force Audit Agency report showed that war reserve requirements were overstated by $19.7 million because inadequate guidance and training was provided regarding the importance of using accurate essentiality codes when computing war reserve requirements.

-- Item managers failed to cancel unnecessary or excess on-order material. Failure to cancel unnecessary or excess on-order materials is a long-standing problem that we have been reporting on at least since 1974. More recently, in March 1990 we reported how the Defense Logistics Agency item managers were

increasing stated requirements to avoid recommending terminations. Lax or nonexistent supervision allowed questionable decisions not to recommend terminations to go unreversed. At one supply center, contracts were not considered for termination if they fell below $25,000, a threshold that excluded 98.5 percent of the center's contracts. We recently reviewed the March 1991 inventory reports and found that DOD still had $2.5 billion of material on order that was excess to requirements.

-- Management controls were ineffective. The inventory requirements determination problems that have contributed to excess inventory growth have continued because of fundamental shortcomings in DOD's management control systems. For example, in August 1988 the Army Audit Agency reported that the Army Materiel Command needed to exercise greater control over the initial provisioning process to ensure that new systems were fully supported at the least possible cost. According to the report, the commodity commands frequently requested more funds and acquired and fielded more items than needed to support new systems.

EXCESS RETAIL INVENTORIES

Our work has shown that excess stock occurs at retail levels and sometimes the wholesale level is buying these same items. We have

reported on this problem in both the Army and Air Force. For example, in January 1990, we reported that 13 Army divisions had $184 million worth of spare and repair parts that were excess to their needs and had not been reported to the buying commands. At the same time, we found that three Army buying commands were in the process of procuring 1,669 of these same items worth $66.9 million.

In July 1991, we reported that between September 1987 and March 1990, inventories of consumable items and low-cost equipment that were excess to Air Force retail activities' war reserve and peacetime operating needs increased from $442 million to $927 million, or 110 percent. Wholesale item mangers had visibility over only a small portion of the retail-level excess. As a result, wholesale managers procured items valued at millions of dollars that were excess at retail-level activities and opportunities for redistributing assets were missed. For example, we compared retail-level excesses on hand, valued at $108.3 million, at 14 retail activities as of March 31, 1990, with procurement actions being taken at the wholesale level and found that there were ongoing or planned procurements for $32.1 million, or 29.6 percent, of these retail excesses. The wholesale managers were aware of only $1.5 million, or about 5 percent, of the $32.1 million in retail excess.

COMMERCIAL PRACTICES

In the past year, we issued two reports where we compared commercial practices to what DOD had done for F-108 aircraft engines and medical supplies. In both cases, we found DOD could save millions of dollars by adopting commercial practices.

In the area of medical inventory, we reported that DOD can save millions of dollars by increased use of inventory management practices pioneered by leading civilian hospitals. Military medical facilities and warehouses hold large amounts of medical inventory. In contrast, very progressive civilian hospitals maintain much smaller levels of supplies. These hospitals, through improved ordering systems, standardization of supplies, and better communication with vendors, have greatly reduced inventories. These hospitals claim that such improvements have reduced their inventory costs and improved patient care.

We believe there are numerous other opportunities to obtain materials directly from suppliers where the commercial sector has well-established manufacturing and distribution systems. We are looking into the possibilities of moving more DOD supply areas to "just-in-time" and "stockless" delivery systems, and eliminating the need to throw away out-of-date inventory.

COST OF MAINTAINING INVENTORY

We have not developed a cost for DOD to maintain inventory. However, for fiscal year 1992, DOD estimated that it would obligate about $3.6 billion to operate its supply system. In addition, DOD inventory control points use holding costs to calculate the optimum number of items to buy. The cost to hold inventory includes four factors:

-- an investment cost of 10 percent per dollar per year,

-- a storage cost of 1 percent per dollar per year,

-- a variable obsolescence cost percent per dollar per year, and

-- a variable percent per dollar per year for other losses.

Of particular interest is the investment cost that represents money tied up in carrying inventory that could be put to alternative uses. Since funds are limited and the federal government is paying interest on borrowed funds, it is important that they are put to their best use and not expended earlier than necessary.

BUDGET REDUCTIONS AND

OTHER ACTIONS ARE NEEDED

We see tremendous potential for improvements in DOD's inventory systems. These improvements will translate into significant savings. DOD managers need to establish goals for reducing the inventory they are storing and maintaining. Achieving these goals will require them to:

-- stop buying items so far in advance;

-- terminate orders for unneeded materials;

-- change the organizational culture so they will have an efficient supply system and will not need to rely on overstocking to ensure being able to fill orders;

-- rapidly increase the use of commercial practices in all the areas, such as medical, where commercial supply systems are well-established; and

-- clear the warehouses of old, obsolete, and unneeded items.

It is possible that the current disposal processes will not be effectively able to facilitate prompt clean out of the supply depots and that a supplemental approach will be needed until the

aggressive reduction goals are met. We are in the process of looking into this.

In addition, supply depots need to be considered for closure along with other bases during the ongoing base closure and realignments process. The actions I've suggested are preparatory to being able to do this and are a necessary part of creating a modern supply system that takes advantage of the latest up-to-date logistics concepts.

Also, reductions in force structure and associated reduced operating tempos will translate into reduced demands on the inventory system, and supplies held by units and bases being closed should be returned to the system. We believe that the Congress needs to maintain close oversight of DOD's inventory reduction efforts. Congressional attention is needed to sustain the momentum for reducing inventories and to keep top DOD management focused on this issue.

DOD has established an inventory reduction plan with goals to do many of the things I outlined above. This plan includes objectives to:

-- minimize the quantity of new items entering the supply system,

-- reduce the number of items currently in the system,

-- reduce the quantities of material stocked,

-- pursue commercial alternatives to material stockage, and

-- improve material control and asset visibility.

DOD needs to continue its efforts to improve inventory management, but the Congress may wish to give a sign in the form of a budget reduction to show how serious it is in its desire to see improvement in DOD's inventory management. Making budget reductions to achieve such improvements is not a new idea. Last year Congress did it. A number of private sector firms we surveyed, when they decided to cut inventory levels, set inventory reduction goals and reduced inventory dollars. Similarly, DOD used the technique of reducing supply dollars to encourage increasing supply system efficiency.

The President's fiscal year 1993 defense budget is for about $268 billion. The 1993 budget represents about a $10-billion reduction to the 1992 budget.

On January 28, 1992, before the fiscal year 1993 budget was available, in response to his request, I advised Senator Levin that we believed the amount budgeted for secondary items in fiscal year 1993 should be at least $5 billion below the amount budgeted in fiscal year 1992. I would like to clarify this statement to say $5

billion below the amount appropriated for fiscal year 1992. At this time, we do not know how much DOD has budgeted to buy inventory and operate its supply systems. However, I am convinced that the Congress needs to reduce DOD's budget by billions of dollars and reinforce its desire for DOD to improve inventory management.

I am basing this recommendation on a number of things:

-- a reduced future force level that will need to be supported,

-- our assessment of March 1991 inventory reports that revealed $2.5 billion of material on order in excess of requirements,

-- our examinations of wholesale inventories which regularly reveal items that are overstocked,

-- our examinations of retail inventories which regularly reveal excess stocks,

-- the move to just-in-time type practices for items easily available commercially which will reduce the need for large stocks, and

-- about $3.4 billion in extra stocks that DOD estimates were left over from Operation Desert Storm.

Last year, we pointed out that DOD's inventory budget was in several accounts and that documents do not always disclose the requested amounts or how much was for inventory. As a result, we could not identify an exact figure for secondary items for the fiscal year 1992 inventory budget. DOD estimated that it would obligate about $25 billion in fiscal year 1992 to purchase secondary items and operate supply centers.

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Mr. Chairman, that concludes my prepared testimony. I would be pleased to answer questions at this time.