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Report to the Chairman, Subcommittee on Oversight of Government Management, Committee on Governmental Affairs, U.S. Senate

March 1993

DEFENSE INVENTORY

Defense Logistics Agency's Materiel Returns Program

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National Security and
International Affairs Division

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March 30, 1993

The Honorable Carl Levin
Chairman, Subcommittee on Oversight
of Government Management
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

As you requested, we examined the cost-effectiveness of the Defense Logistics Agency's (DLA) materiel returns program and the related policies and procedures that govern it.

Background

DLA is responsible for providing logistics support, including procuring, stocking, and issuing consumable items, to the military services and other government agencies. DLA also manages the return of excess materiel from its customers to be restocked at its depots.

DLA uses criteria, including the amount of stock on hand and the total value of the return, to determine whether to authorize a return. Returns whose stock on hand is below the stock objective—generally a 30-month supply—are approved for return regardless of their value. Returns whose stock on hand exceeds the stock objective are not approved if the materiel's value is less than the minimum return limit, which DLA established in June 1992, at $25 (i.e., a return should be worth at least $25 for DLA to process it back to a depot). DLA officials estimated that 80 to 90 percent of the decisions on whether materiel should be returned are made solely by a computer.

From fiscal years 1988 to 1991, DLA received between 1.1 million and 1.4 million authorized returns each year. In fiscal year 1991, returns accounted for 67 percent of all depot receipt transactions (new procurements and customer returns). Toward the end of fiscal year 1992, returns had increased to over 80 percent of all receipts at some depots. Depot officials said that most returns were low-value items. For example, in fiscal year 1991, about one-half of the returns were valued at $50 or less, and almost one-third were valued at $20 or less. Moreover, DLA received about 57,000 returns with a value of less than $1 each in the year ending May 1992.

Depot officials complained that they were receiving too many low-value returns that cost more to process than they were worth and that they could not process all returns in a timely manner. These officials said that they were either working overtime to process the large volume of returns or were building backlogs. At the end of fiscal year 1992, DLA's six principal depots had a backlog of almost 182,000 unprocessed returns.

DOD officials said that in terms of real growth, returns have only increased about 6 percent from fiscal years 1988 to 1992. These officials added that another factor that influenced the number of returns being processed by DLA was depot consolidation, since items that the services formerly returned to their own depots were now being returned to DLA for custodial purposes.

Results in Brief

DLA could avoid millions of dollars in processing costs by (1) eliminating the return of materiel valued at less than the cost to process it into a depot, (2) applying the minimum value to all returns regardless of the amount of stock on hand, and (3) valuing more realistically the materiel being considered for return. DLA's minimum limit of $25 is less than the cost to process a return into a depot. We found that the average cost of processing returns in fiscal year 1991 was $40. Also, DLA includes surcharges in determining the value of materiel being returned, which can add up to 49 percent to the acquisition price and therefore overvalue the materiel. As a result, more items are being approved for return than should be.

If DLA had applied the $40 limit to all returns and did not overvalue materiel, we estimate that it could have eliminated about 611,000, or 42 percent, of the returns between June 1991 and May 1992 at a processing cost of approximately $24.4 million.

Minimum Return Limit Should Be Increased and Applied to All Returns

DLA officials said that the $25 minimum return limit represented the estimated average cost of processing a return back into a depot during the first 5 months of fiscal year 1991. We asked DLA officials to compute the average processing cost for all of fiscal year 1991, and they determined the amount to be $29.

In addition to the processing cost, we found that up to 46 percent of the returns during fiscal year 1991 required additional work before they were able to be stored or reissued. The additional work included packaging, packing, preserving, palletizing, and marking. We determined that the average additional cost per return at four of DLA's principal depots was about $11.[1] When the average additional cost was added to the average processing cost, the overall average cost to process a return in fiscal year 1991 was $40. DLA officials agreed that this additional work was a legitimate cost of processing a return and should have been included in its minimum return limit. If DLA had applied a $40 limit rather than $25 to those returns whose stock exceeded the 30-month supply, about 40,000 returns could have been eliminated between June 1991 and May 1992.

DLA could reduce the number of returns even more if the return limit were applied to materiel whose stock level was below the 30-month stock objective. Our analysis showed that DLA could have eliminated about 485,000 returns between June 1991 and May 1992 if the 30-month criterion had not been applied. Thus, if a $40 limit had been applied to all returns between June 1991 and May 1992, DLA could have eliminated in total about 525,000 returns at a processing cost of $21 million. Because some processing costs are fixed, we recognize that DLA would not have directly saved the entire amount. However, by eliminating the large number of returns, the work load at the depots will be reduced, which should permit reductions in the number of personnel and other costs.

Applying a minimum return limit to all materiel would also eliminate many unreasonable returns. Returns of items in small quantities and with values under $1 are routinely and automatically approved by DLA because of the 30-month stock objective. For example, DLA approved the return of 3 bolts from Germany, even though it already had almost 51,000 bolts on hand (a 15-month supply) and subsequently received a new procurement of 17,800 more. Figure 1 shows the three bolts, valued at $1.17, that were returned from Hahn Air Base, Germany. Figure 2 shows another example of an unreasonable return—1 yard of nylon cord, valued at $0.34, returned from an Air Force Air Logistics Center.

[1]This amount was derived by adding the total cost for the additional work and dividing it by the total number of returns. Similar data were not available at DLA's other two principal depots.

Figure 1: Bolts Returned From Hahn Air Base, Germany

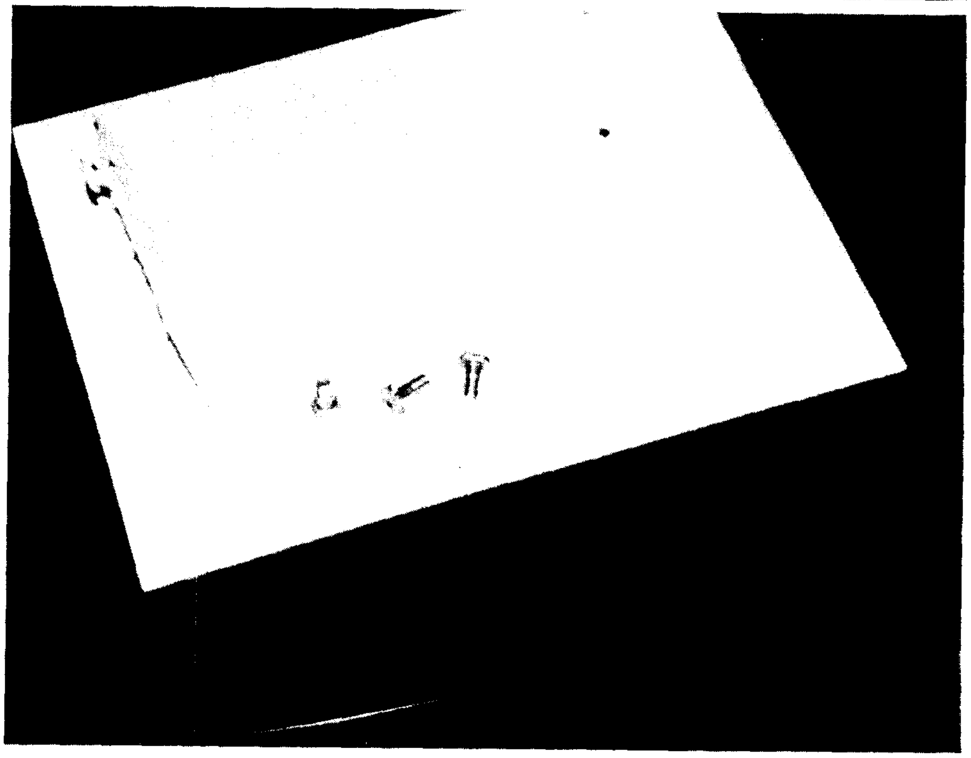
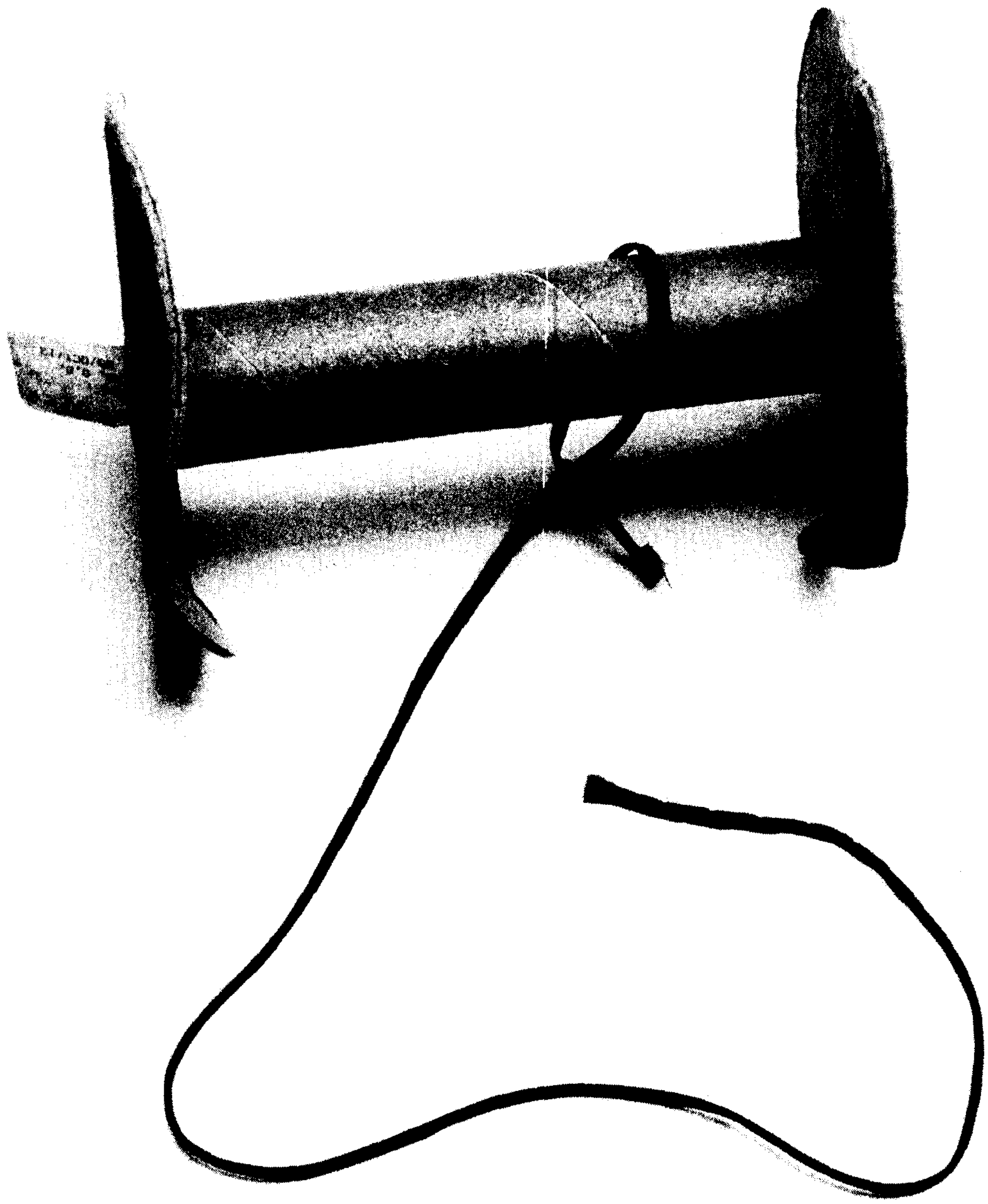


Figure 2: Nylon Cord Returned From an Air Force Air Logistics Center



Some DLA officials agreed that all returns needed to be subjected to a minimum limit regardless of the amount of stock on hand to ensure that their return is cost-effective. However, Department of Defense (DOD) and DLA officials were concerned that raising the minimum return limit and applying it to all returns would increase the amount of materiel being procured, raise costs, eliminate the return of materiel that is hard to procure or critically needed, and cause additional problems for customers regarding the retention or disposal of materiel.

We found that the return of low-value items did little to offset the need to buy new materiel because additional items would have been purchased regardless of the returns. Our analysis showed that for those returns under $40, 55 percent represented only a 1-day supply of stock or less, and up to 85 percent equaled a 5-day supply or less. Also, low-value returns cannot be reliably counted on to meet critical short-term requirements because customers are given up to 4 months for returns to the depot within the United States and 6 months if overseas. Although we realize that DLA would have to increase purchases to offset the loss of these returns, it is more cost-effective to procure new low-value materiel in large quantities than to pay more to process the returns in small quantities.

Moreover, about 64,500 returns valued at under $40 (about 4 percent of the 1.5 million returns) that were processed by DLA between June 1991 and May 1992 were found to be unserviceable, even though the customers had categorized these items as serviceable. The $1.9 million cost to process these returns at the depots was wasted, since this materiel was subsequently sent to property disposal and the materiel—if eventually needed—would have been reprocured anyway.

DLA officials also commented that all return decisions should not be based solely on cost-effectiveness. They said that certain noneconomic factors, such as an item's availability, should continue to be considered when deciding whether a return should be approved. We agree that some exceptions for noneconomic reasons are justified, for example when an item is unavailable in current inventories or is only available from a diminishing number of manufacturing sources.

Value of Returned Materiel Should Be Based Solely on Acquisition Price

DLA purchases materiel from vendors and pays the acquisition price for each item. Since DLA must recover its operating costs, which include procuring, managing, handling, storing, and issuing the materiel, it establishes a yearly surcharge rate that is applied to all sales. In fiscal year 1992, the rate varied by commodity from 18.8 percent for subsistence items to 49.1 percent for industrial items. The acquisition price plus the surcharge rate is commonly referred to as the standard price, which is the price DLA sells the item to its customers.

When determining whether to accept a return, DLA values the item at its standard price, not the acquisition price, which is the amount it would actually cost DLA to reprocure the item. As a result, the value of an item is inflated, and more returns are being authorized than should be. In our opinion, the acquisition price should be used because many of the same components of the surcharge would be incurred again as the materiel is returned to the depot and processed back into storage and then recouped when the materiel is reissued. Also, when DLA provides the customer with credit for materiel returned, that credit is limited to the current acquisition price. DLA could have reduced the number of returns by an additional 86,000 and avoided processing costs of $3.5 million between June 1991 and May 1992 if it had valued returns at their acquisition price.

Recommendations

We recommend that the Secretary of Defense require the Director, DLA, to (1) establish annually a minimum return limit based on the total cost to process a return; (2) apply that limit to all returns except when there are valid exceptions, such as when an item is unavailable in current inventories or is only available from a diminishing number of manufacturing sources; and (3) use acquisition price as the criterion for valuing returns.

Agency Comments

DOD generally agreed with our findings and recommendations (see app. I). DOD stated that by July 1993 it would require DLA to use acquisition price as the criterion for valuing returns. DOD also stated that it would require DLA to periodically update the minimum dollar value for returns.

DOD stated that the minimum dollar threshold should not apply universally. It believed that the integrated materiel manager should determine when to authorized a return and that the manager's decision should be based on all relevant information (e.g., whether an item is essential to maintaining readiness and whether an item may be difficult to reprocure in the future). DOD stated, however that it would require DLA to review the 30-month objective for items it manages with the intent of reducing the quantities required. DOD believed that this effort should reduce the requirement for stock on hand and, consequently, reduce the number of returns.

Scope and Methodology

We conducted our work primarily at DLA headquarters, Cameron Station, Virginia, and at five of DLA's six principal distribution depots—the Defense Depot, Columbus, Ohio; Defense Distribution Depot, Memphis, Tennessee;

Defense Depot, Ogden, Utah; Defense Depot, Richmond, Virginia; and Defense Distribution Depot, San Joaquin, California. We also visited two of DLA's six supply centers—the Defense Construction Supply Center, Columbus, Ohio, and Defense Electronics Supply Center, Dayton, Ohio. We obtained information about stock status, returns, and procurement from the Defense General Supply Center, Richmond, Virginia; Defense Industrial Supply Center and Defense Personnel Support Center, Philadelphia, Pennsylvania; Defense Distribution Region East, New Cumberland, Pennsylvania; and Defense Distribution Region West, Stockton, California.

We reviewed pertinent documents and interviewed DLA officials to identify controls and procedures guiding the materiel returns program. To obtain customer returns information during fiscal year 1991, we obtained data from DLA on its new procurement receipts and customer returns from the five supply centers, the six principal distribution depots, and each of the services.

DLA provided us with copies of the Customer Returns History Files, excluding subsistence and fuels, from each of the supply centers for the period of June 1991 through May 1992. We used this information to analyze the returns for that period but did not independently verify it.

We used data provided by DLA to estimate the cost of processing customer returns. We based our average cost estimate on DLA's cost estimates plus depot costs that were not included in DLA's estimate. We did not independently verify these data, but we did obtain the views of officials in the DLA comptroller's office on the reasonableness of the data.

To determine whether customer returns were processed in accordance with DLA procedures and in an economical manner, we picked judgmental samples from the processing lines at the depots we visited. We stratified their values into four ranges, with a maximum value of $40.

We conducted our work from December 1991 to November 1992 in accordance with generally accepted government auditing standards.

As arranged with your staff, unless you 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 the Secretary of Defense and the

Directors of DLA and the Office of Management and Budget. We will also make copies available to others on request.

Please contact me on (202) 512-8412 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

Sincerely yours,

Donna M. Heivilin
Director, Defense and NASA
Management Issues

Comments From the Department of Defense

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, DC 20301-8000

PRODUCTION AND LOGISTICS

March 10, 1993

(L/MRM)

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "DEFENSE INVENTORY: DLA's Materiel Returns Program," Dated February 9, 1993 (GAO Code 398103), OSD Case 9321. The DoD generally concurs with the report.

The DoD agrees that cost savings are possible by eliminating the return of many items that are lower in value than the cost of processing the return. Accordingly, by July 1993, the Office of the Secretary of Defense will direct the Defense Logistics Agency to (1) review the acquisition objective for items that it manages with the goal of reducing the requirement for inventory, and (2) to establish a minimum dollar value for materiel returns. That dollar value will apply to all non-credit returns, and it will be reviewed periodically to ensure that current costs to process a materiel return are reflected.

With respect to items that are returned for credit, there are valid reasons to grant exceptions to the minimum dollar value threshold. These exceptions are essential in order to maintain readiness and avoid unnecessary future procurement costs.

The detailed DoD comments on the draft report findings and recommendations are enclosed. The DoD appreciates the opportunity to comment on the draft report.

Sincerely,

Jeffrey A. Jones
Acting Deputy Assistant
Secretary (Logistics)

Enclosure

GENERAL ACCOUNTING OFFICE DRAFT REPORT--DATED FEBRUARY 9, 1993
(GAO CODE 398103) OSD CASE 9321

"DEFENSE INVENTORY: DLA'S MATERIEL RETURNS PROGRAM"

DEPARTMENT OF DEFENSE COMMENTS

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FINDINGS

o **FINDING A**: **The Defense Logistics Agency Materiel Returns Program**. The GAO reported that the Defense Logistics Agency (Agency) provides logistics support to the Military Services and other Government agencies--including procuring, stocking, and issuing consumable items. The GAO pointed out that the Agency also manages the return of excess materiel from customers to be restocked at the depots. The GAO further reported that the Defense Logistics Agency uses criteria, including the amount of stock on hand and the total value of the return, to determine whether to authorize a return. The GAO found that, during the period from FY 1988 to FY 1991, the Agency received between 1.1 and 1.4 million authorized returns each year. The GAO noted that, in FY 1991, returns accounted for 67 percent of all depot receipt transactions--but by the end of FY 1992, returns had increased to over 80 percent of all receipts at some depots. The GAO noted that most returns were low-value items valued at $50 or less. The GAO observed that, at the end of FY 1991, the six principal Defense Logistics Agency depots had a backlog of almost 182,000 unprocessed returns. The GAO further noted, however, that DoD officials said that in terms of real growth, returns have only increased about six percent from FY 1988 to FY 1992. The GAO also noted that another factor which has influenced the number of returns being processed by the Defense Logistics Agency is that, as a result of depot consolidation, items which the Military Services formerly returned to their own depots are now being turned over to the Defense Logistics Agency for custodial purposes. (pp. 1-3/GAO Draft Report)

Now on pp. 1-2.

DoD Response: Concur. In conjunction with the ongoing DoD Inventory Reduction Program, the Defense Logistics Agency is experiencing a significant decrease in the volume of receipts from new procurement being processed into depot stock. As a result, returns have increased as a percentage of depot workload in recent years. That increase is principally the result of the decreased basic depot

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workload, which is related to the procurement of new material.

Because the force structure is declining and financial controls have been imposed which limit the rate at which the DoD supply system can replace the items it sells, the depots are processing a smaller number of receipts from new procurement. Consequently, when the number of returns remains relatively constant, but the balance of the depots' workload declines significantly, the percentage of returns as a portion of total workload increases. It is quite understandable that the GAO found that approximately 50 percent of the returns processed by the Defense Logistics Agency in FY 1991 were valued at $50 or less, since 70 percent of the items managed by the Defense Logistics Agency cost less than $50.

The GAO report focused on the number of unprocessed returns at the six principal Defense Logistics Agency depots. However, the report does not identify the portion of that backlog that has been directed for return to the Defense Logistics Agency wholesale system, relative to other types of returns. Other returns include both items which the Military Services have directed to be returned to the depot for storage against Service retail accounts and returns which were never authorized. When those facts are considered, it is apparent that the Defense Logistics Agency does not have complete control over surges in the volume of workload associated with returns.

o **FINDING B**: **Minimum Return Limit Should Be Increased and Applied to All Returns**. The GAO reported that, in June 1992, the Defense Logistics Agency established a minimum return limit of $25--i.e., a return should be worth at least $25 in order to be processed back to a depot--which was the estimated average cost of processing a return for the first 5 months of FY 1991. The GAO noted, however, that Defense Logistics Agency officials determined the average processing costs for all of FY 1991 to be $29. In addition to the processing cost, the GAO found that up to 46 percent of the returns during FY 1991 required additional work--packaging, packing, preserving, palletizing, or marking--before the returns were able to be stored or reissued. The GAO determined that the average additional cost per return at four principal depots was $11. The GAO concluded, therefore, that when added to the average processing cost of $29, the overall average cost to process a return in FY 1991

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was $40. The GAO noted that, if the Defense Logistics Agency had applied a $40 limit, rather than $25, to the returns whose stock exceeded the 30-month supply, about 40,000 of the returns between June 1991 and May 1992 could have been eliminated. The GAO further concluded that the Defense Logistics Agency could reduce the number of returns even more if the return limit were applied to materiel whose stock level was below the 30-month objective. The GAO also concluded that applying a minimum limit to all materiel would also eliminate many unreasonable returns.

Now on pp. 2-6.

The GAO found that the return of low-value items did little to offset the need to buy new materiel, because additional items would have been purchased regardless of the returns. The GAO analysis showed that, for those returns under $40, 55 percent represented only a 1-day supply of stock or less--and up to 85 percent equaled a 5-day supply or less. The GAO agreed that the Defense Logistics Agency would have to increase purchases to offset the loss of the returns. The GAO concluded, however, that it would be more cost-effective to procure new low-value materiel in large quantities than to pay more to process the returns in small quantities. The GAO also determined that about 64,000 returns valued at under $40 (about 5 percent of the total returns), were processed by the Defense Logistics Agency between June 1991 and May 1992, and found to be unserviceable--even though the customers had categorized the items as serviceable. The GAO concluded that the $1.9 million cost to process the returns at the depots was wasted, since the materiel was subsequently sent to property disposal--and the materiel, if eventually needed, would have to be reprocured anyway. The GAO did agree, however, that some exceptions for non-economic reasons--such as the availability of an item--are justified. (pp. 4-8/GAO Draft Report)

DoD Response: Concur. Although the DoD concurs that a minimum dollar value should be established as a threshold amount for the return of materiel, the universal application of that amount to all returns would be counterproductive in light of the purpose for establishing the threshold. The GAO states that the Defense Logistics Agency established a $25 threshold for returns in 1992. That threshold was established only for non-creditable returns. To the extent that the cognizant inventory control point determined that

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there was sufficient demand for the item to warrant granting credit to the returning activity, no dollar threshold was to be applied before the material was returned.

With respect to returns for which the inventory control point elects to grant the returning activity a financial credit, readiness issues ought to take priority over economic considerations. In some cases, the item involved is a critical item. Sometimes the item is unavailable in current inventories and a backorder has been placed. In other cases, the item is only available from a diminishing number of manufacturers and is expected to become increasingly difficult to obtain in the future. In those and other exceptional circumstances, customer support should be paramount, and the value of the items themselves should be a secondary consideration.

o **FINDING C: Value of Returned Materiel Should Be Based Solely on Acquisition Costs**. The GAO reported that the Defense Logistics Agency purchases materiel from vendors and pays the acquisition price for each item. The GAO found that, in order to recover operating costs--which include procuring, managing, handling, storing, and issuing the materiel--the Agency establishes a yearly surcharge rate that is applied to all sales. The GAO observed that in FY 1992, the rate varied by commodity, from 18.8 percent for subsistence items to 49.1 percent for industrial items. The GAO noted that the acquisition price, plus the surcharge rate, is commonly referred to as the standard price--and is the price at which the Agency sells the items to customers.

The GAO found that, when determining whether to accept a return, the Defense Logistics Agency values the item at standard price--not the acquisition price. The GAO concluded that, as a result, the value of an item is inflated, and more returns are being authorized than should be. The GAO concluded that, instead of the standard price, the acquisition cost should be used because many of the components of the surcharge will be re-incurred as the materiel is (1) returned to the depot, (2) processed back into storage, and (3) then recouped when the materiel is reissued. The GAO further found that when the Defense Logistics Agency provides the customer credit for materiel returned, that credit is limited to the current acquisition cost. In summary, the GAO concluded that the Defense Logistics Agency could have reduced the number of returns by an additional 86,000 items and avoided processing costs of

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Now on pp. 6-7.

$3.5 million between June 1991 and May 1992--if returns had been valued at the acquisition price. (pp. 8-9/GAO Draft Report)

DoD Response: Concur

* * * * *

RECOMMENDATIONS

Now on p. 7

- **RECOMMENDATION 1**: The GAO recommended that the Secretary of Defense require the Director, Defense Logistics Agency, (1) to establish annually a minimum return limit based on the total cost to process the return and (2) to apply that limit to all returns, except when there are valid exceptions such as an item is unavailable in current inventories or is only available from a diminishing number of manufacturing sources. (p. 10/GAO Draft Report)

DoD Response: Concur. By July 1993, the Office of the Secretary of Defense will establish a requirement that the Defense Logistics Agency establish a minimum dollar value for non-credit returns and periodically review that value. That limit will be based on the average cost to process such returns.

With respect to the return of items for which the cognizant inventory control point issues a financial credit to the returning activity, the minimum dollar threshold should not apply universally. When an integrated materiel manager determines that there is a valid reason to grant a financial credit to an activity as an incentive to return an item, the decision as to whether or not it is cost-effective to return the item should be made by the integrated materiel manager on the basis of the totality of the circumstances. The recognition of valid exceptions is essential to maintaining readiness and avoiding costly reprocurement of items that may prove difficult to obtain in the future.

Additionally, by July 1993, the Office of the Secretary of Defense will direct the Director, Defense Logistics Agency, to review the approved acquisition objective for items that the Defense Logistics Agency manages, with the objective of reducing the quantities involved when appropriate. That effort should reduce the requirement for stock on hand and help to minimize the number of returns.

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Now on p. 7.

o **RECOMMENDATION 2**: The GAO recommended that the Secretary of Defense require the Director, Defense Logistics Agency, to use acquisition costs as the criterion for valuing returns. (p. 10/ GAO Draft Report)

DoD Response: Concur. By July 1993, the Office of the Secretary of Defense will direct the Director, Defense Logistics Agency, to use acquisition costs as the criterion for valuing returns.

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