Testimony

STATEMENT FOR THE RECORD
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BEFORE THE
SUBCOMMITTEE ON READINESS AND MANAGEMENT SUPPORT
SENATE COMMITTEE ON ARMED SERVICES
ON
ACQUISITION REFORM IN THE
DEPARTMENT OF DEFENSE

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Office of the Inspector General
Department of Defense

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to share with you our view on acquisition reform efforts at the Department of Defense. At the outset, I want to emphasize that the Office of the Inspector General (OIG) has for some time been a strong supporter of acquisition reform. During this past year, we have continued our efforts to help the Department and Congress identify barriers to more efficient acquisition practices, design new processes, and evaluate the impact of the changes already in place.

OBSERVATIONS ON REFORM

We are encouraged by the progress the Department is making in some areas of the acquisition reform effort. For example, we recently reported that DoD components implemented many initiatives to reduce acquisition lead-time. The changes have allowed DoD components to reduce acquisition lead-time by an average of 14 percent with some activities achieving a 50-percent reduction since our 1995 review. The reductions in lead-time reduce the amount of inventory needed on the shelf or the time the warfighters have to wait for a part.

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Acquisition reform initiatives such as promoting electronic commerce and encouraging the use of commercial purchasing practices are focused on expediting procurements, cutting red tape, and reducing overhead costs. However, much more needs to be done to ensure that the DoD acquisition work force is capable of transitioning to new practices and that those new practices include reasonable controls to safeguard against the continuing threat of procurement fraud and mismanagement. There have been many positive acquisition reform initiatives. However, except for acquisition lead time, we have not yet seen significant across the board improvements in cycle time and unit costs.

CHALLENGES IN THE OVERSIGHT OF ACQUISITION

The Office of Inspector General has broad statutory authority to conduct oversight within DoD, including the area of acquisition. The sheer magnitude of the acquisition program, however, makes effective oversight a monumental challenge. In FY 1998, DoD purchased over

$131 billion of goods and services on over 250,000 contracts, grants, cooperative agreements, and "other transactions." Currently, DoD is administering over $800 billion in open contracts. At the end of June 1998, DoD had 79 major Defense Acquisition programs, valued at over $674 billion, of which over half had yet to be appropriated. In addition, there are hundreds of small programs.

The consolidations in the Defense industry are reflected by the fact that the top three contractors for DoD account for about 25 percent ($29 billion) of all contracts over $25,000. The top 10 contractors for DoD account for 37 percent ($43.5 billion) of all contracts.

Because of the risks in acquisition, the Office of Inspector General has historically given high priority, to the extent our resources permit, to the oversight of acquisition programs and functions. In the last year, we issued 57 audit reports on acquisition issues. To augment our audits, we are participating on Department process action teams and working groups such as joint contracting, commercial business environment training, and product support. Our participation allows us to provide input regarding management controls before new processes are fielded. Also, procurement fraud remains the largest part of the workload of the Defense Criminal Investigative Service (DCIS), the criminal investigative arm of this office. Over the past 5 fiscal years, DCIS cases related to procurement have resulted in 948 convictions and $1.1 billion in recoveries. We currently have over 800 open criminal cases on bribery, conflict of interest, mischarging, product substitution, false claims, and other procurement matters.

I want to highlight some examples of our work in the acquisition area.

SPARE PARTS AUDITS

There are many challenges in buying spare parts in the acquisition reform environment. Our review of spare parts acquisitions has covered a sample of six corporate contracts issued by the Defense Logistics Agency (DLA). The DLA has about 43 corporate contracts for spare parts.

We have not reviewed spare parts purchases by the Services, but we believe that the same purchasing challenges exist across the Department.

Last year, I testified before the Subcommittee on Acquisition and Technology, Committee on Armed Services, about two reports on spare parts pricing. The first report showed that the DLA paid (for sole-source commercial spare parts) modestly discounted catalog prices that were significantly higher (average increase of about 280 percent) than previous cost-based prices. The second report showed that the sole-source prices for spare parts on a different contract, were 172 percent higher than the competitive (breakout) prices previously paid by DoD for the spare parts. DLA purchased commercial catalog and noncommercial spare parts on a sole-source basis, principally because those spare parts were mistakenly coded by DLA as sole-source when inventory management responsibility was transferred from the Air Force.

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RESPONSE TO AUDITS

In written responses to the first audit, the Under Secretary of Defense for Acquisition and Technology and the Director, DLA, agreed to take various actions. The Under Secretary agreed that additional training and guidance were needed relating to commercial items, but did not agree that obtaining uncertified cost or pricing data or access to contractor cost data was needed to establish price reasonableness.

In March 1998, the Under Secretary testified before the Subcommittee on Acquisition and Technology, Committee on Armed Services, about the spare parts issue. The Under Secretary was asked whether draft commercial pricing guidance (draft commercial pricing "Information Guide," dated February 1998) prepared by the Under Secretary's Acquisition Reform office was inconsistent with the statutory directive that contracting officers require contractors to provide information (other that certified cost or pricing data) to the extent necessary to determine the reasonableness of price. The Under Secretary stated, "I do not agree that the guidance is inconsistent with the existing statute. In implementing the statute, we made it clear that one asks the offeror for information as the last resort, after exhausting all other sources of pricing information. However, we will make it clear in the final

guide that information may be obtained from the offeror if needed to determine price reasonableness where sufficient information cannot be obtained from other sources." To date, we have been unable to locate any place where the Department has taken action to publish final guidance that clearly confirms the right to seek such information if necessary.

The Defense Authorization Act for Fiscal Year 1999 included provisions requiring the Department to publish guidance in the Federal Acquisition Regulation to help contracting officers address the problems identified by the audits last March. To date, the Office of the Under Secretary of Defense (Acquisition and Technology) has not yet issued the additional guidance required by the Act. We were recently informed it would be months before this guidance is published. The Authorization Act also tasked the Department to develop procedures for unified management of exempt commercial items, prompted by the reports that DoD has multiple contracting offices and contracting officers negotiating with the same contractors. On this issue, I was informed that a working group was formed and will initially meet on March 25. However, it may be months before any new procedures are developed.

In December 1997 in response to our first audit, DLA awarded a new indefinite-delivery contract for 216 sole-source commercial items. The contract will save, according to DLA, about $83.8 million over a 6-year period. The contract includes some of the items addressed in our first audit report. The negotiations took 3 months for the contract and were very difficult. The audit also recommended that DLA negotiate a long-term contract for a significantly larger number of noncommercial items (over 1,500 spare parts) with the aid of cost data. Although DLA issued a sole-source solicitation to the contractor in December 1997, as of December 1998, the contractor has declined to offer prices or provide cost data. The contractor is now claiming all the spare parts are commercial items, thus making it difficult, if not impossible, for DLA to negotiate fair and reasonable prices for these sole-source spare parts. In response to the second audit, DLA agreed to identify items that could be broken out to other sources, obtain the manufacturing drawings, and procure items competitively in the future.

RECENTLY COMPLETED AUDIT

Report No. 99-026

A third audit report on the commercial pricing of spare parts was issued in October 1998. The audit showed that DLA supply centers paid higher prices for commercial spare parts when compared to previous noncommercial prices for the same spare parts. The supply centers failed to effectively implement buying and inventory management practices designed to offset the higher commercial prices and take advantage of the contractor's capabilities. DLA supply centers paid the contractor commercial prices for spare parts which included costs for the contractor to manage, stock, and deliver the items directly to users in the field. However, instead of taking advantage of these commercial services, the supply centers purchased large quantities of parts for inventory and applied their full cost recovery rates to manage, stock, and deliver the items to users in the field. Duplication of costs to manage, stock, and deliver the items increased customer costs by about $3.2 million in FYs 1996 and 1997. Based only on the data reviewed for FY 1997, we calculate that DLA supply centers can reduce total ownership costs for their customers by at least $12.5 million during FYs 1999 through 2004 if the corporate contract is effectively implemented as intended. The DLA is working on correcting this problem.

ONGOING SPARE PARTS AUDITS

We currently are working on three additional audits involving commercial and noncommercial pricing of spare parts in the acquisition reform environment. Draft reports on the first two audits will be issued in March 1999, with the third report to follow. We are again identifying problems in the purchasing of spare parts on sole-source corporate contracts. Based on our work thus far, we believe that the results will further confirm our belief that access to accurate cost information is critical to the best interests of DoD in sole-source procurements situations.

SERVICE CONTRACTS

DoD support service contracting continues to be a high-risk area for waste and mismanagement. Support services is an area that has grown to $48 billion in FY 1998 and has received far less attention from senior DoD

acquisition officials than it deserves. During the past year, we issued several reports on services contracting that highlighted problems with the lack of competition, potential conflicts of interest, and poor contract administration.

In March 1999, we issued a report that identified significant problems with the issuance of task orders by DoD components under multiple award contracts. Multiple award contracting allows the Government to procure products and services more quickly, using streamlined acquisition procedures, while using the advantage of competition from pre-qualified bidders to obtain the best prices. All contractors qualified for the contracts are considered technically capable of performing any task order that may be awarded. DoD awarded 636 multiple award contracts from FY 1995 through FY 1998. Each multiple award contract could result in the issuance of numerous task orders. The audit examined orders awarded under 50 multiple award contracts with a total contract ceiling amount of $2.6 billion. We found that contracting officers awarded 66 of 124 (53 percent) task orders for $87.6 million on a sole-source basis without adequate justification for denying other contractors a fair opportunity to be considered. During the audit, we encountered discouraged vendors who were afraid to challenge prospective awards because of concern about future dealings with the same contracting officer and program office. We recommended that the Under Secretary of Defense for Acquisition and Technology take several actions to increase competition in the award of task orders for services under multiple award contracts. Because of reported problems for this area, the Office of Federal Procurement Policy has issued guidance recently to stop program offices from designating preferred vendors and set a goal that 90 percent of the task orders should be competitive.

Report No. 99-116

We also issued a report that was critical of the continued use of a single contractor by the Defense Finance and Accounting Service and the Defense Logistics Agency for contract reconciliation services. We found that DoD officials did not adequately plan for contract reconciliation services and took inappropriate actions that allowed one contractor to be the sole provider of these services for over 9 years without competition. From 1989 through 1998, the contractor received four sole-source contracts for $78 million that were based on inappropriate

Report No. 98-099

justifications, including urgency and uniqueness. By the time of the third contract, even the Commander, Defense Fuel Supply Center, expressed disbelief regarding the justification and approval for a sole-source contract. The Commander, in a note on the justification and approval, wrote, “I don’t believe this, but I signed it.” After issuance of the audit report, the Defense Finance and Accounting Service awarded a multiple award contract on a competitive basis to three contractors and the hourly rates for these services declined by about 40 percent from the prior sole-source contract.

During 1998, we reported that the Office of the Assistant to the Secretary of Defense (Nuclear and Chemical and Biological Defense Programs) did not comply with applicable regulations, contract requirements, and conflict of interest provisions in obtaining contract support services. Specifically, Government facilities and equipment were provided to a prime contractor and subcontractor without contracting officer approval or contract offsets to reflect reduced costs incurred for contract performance; contractor and subcontractor employees were directed to perform services normally associated with prohibited personal service contracts; and one contractor was authorized to perform tasks that involved potential conflicts of interest. The Department agreed to institute corrective actions. Report No. 98-128

Another report concluded that the Defense Special Weapons Agency (now part of the Defense Threat Reduction Agency) acquired the services of members of an Advisory Panel on Nuclear Weapons Effects through an omnibus scientific and engineering technical analysis services contract rather than through the Defense Science Board, an approved Federal Advisory Committee. Six of the seven members of the Advisory Panel were employees of contractors who were likely to have future DoD contracts related to the study area. The procurement of the services did not adequately protect DoD from potential conflicts of interest. The Department agreed to have full financial and potential conflict of interests disclosures from any future advisory panel members. Report No. 98-149

OTHER TRANSACTIONS

Last year, I testified before the Subcommittee on Acquisition and Technology, Committee on Armed Services,

about our work on “Other Transactions.” “Other Transactions” were authorized to encourage commercial firms to join with the Department on research and development efforts. The “Other Transactions” are exempt from the usual controls and oversight mechanisms set forth in acquisition statutes and the Federal Acquisition Regulation. “Other Transactions” are also exempt from audit access for examination of contractor records by the General Accounting Office and Defense Contract Audit Agency.

For 1990 through October 1999, we believe the Department issued 205 research “Other Transactions,” valued at $2.9 billion, and 97 prototypes “Other Transactions,” valued at $2.1 billion. Research “Other Transactions” are used for basic and applied research and prototype “Other Transactions” are used for prototype projects related to weapons and weapon systems. There are two types of “Other Transactions” because different statutes at different times authorized their use for research and prototypes.

Last year, I reported on problems for 28 “Other Transactions” awarded by the Defense Advanced Research Projects Agency. We outlined the need to put funds advanced to consortiums into an interest bearing account until used; to monitor the actual cost of the work against the funds paid; to ensure that cost sharing arrangements were honored; and to standardize the audit clause. I can report that guidance was issued to correct the problems except for the audit clause issue. We agreed to wait on guidance for the audit clause issue pending additional audit work.

Report No. 97-114

Our recent review of 60 research and 17 prototype “Other Transactions,” valued at $1.2 billion, showed there were still problems in this area. We found that DoD officials did not receive adequate expenditure reporting needed to monitor “Other Transaction” efforts, did not adjust milestone payments when needed, forfeited interest, and did not receive final research reports. The underlying causes were the lack of management guidance, and a lack of quantifiable performance measures to assess costs and benefits. The Department has issued additional guidance, but establishing the performance measures has been difficult for the Department.

Report No. 98-191

We have two audits ongoing on "Other Transactions." Both of these audits should identify issues that will be of interest to this committee. The first is a joint effort with the Defense Contract Audit Agency on how traditional DoD contractors charge costs to "Other Transactions." The report will be released in draft to the Department shortly. The second audit is on the two prototype "Other Transactions," valued at $1 billion, for the Evolved Expendable Launch Vehicle (EELV). We just got started on this review. In comparison to the two "Other Transactions" for the EELV, all of the other 95 prototype "Other Transactions" issued since 1994 are valued at $1.1 billion.

As we reported last year, some continue to propose expansion of the prototype "Other Transactions" authority into the production phase. We continue to doubt the wisdom of this proposal. Though designed to attract new contractors to DoD, available data indicates their participation is limited.

Given the inapplicability of traditional controls to "Other Transactions," we believe that if this authority is extended to billion dollar production runs of equipment, additional scrutiny of pricing for sole-source items will be needed to protect DoD and taxpayer interests. In these cases, the Department should require access to cost or pricing data, plus audit access for the Defense Contract Audit Agency, in order to ensure fair prices.

TRACKING FUNDS NOT USED FOR HARDWARE AND SOFTWARE CONTRACTS FOR MAJOR DEFENSE SYSTEMS

Report No. 99-012

A recent audit examined 10 major weapon systems that had FY 1997 funding of approximately $1.9 billion. Nine of the ten programs did not have cost-accounting systems established to track and report internal DoD program costs by functional categories such as systems engineering, program management, logistics, departmental assessments, test and evaluation, and acquisition of weapon systems hardware and software. Without viable cost accounting systems, it is difficult for program managers to identify where and how to reduce life-cycle costs. Because of the lack of cost-accounting systems, we used budget execution reports to identify functional cost categories within the various appropriations and detailed cost activities associated with those cost categories. We found that an average of 69 percent of the program dollars were used to

fund prime contractors for the development and acquisition of weapon systems hardware and software and the remaining 31 percent was used for noncontract expenses. The 31 percent for noncontract expenses fell into 12 categories. One of the more interesting categories was departmental assessments, which made up 4.96 percent. Departmental assessments are commonly referred to as "taxes" and the program funds were used to pay for the costs for things such as small business innovative research; Bosnian disaster relief; and a Presidential request for anti-terrorism, counter-terrorism, and security enforcement. We could not evaluate reasonableness or compare the 12 cost categories among programs because no one had ever collected the data before and there were no baselines or benchmarks. The lack of a viable cost accounting system for tracking weapon systems costs by functional categories contributes to the risk in managing weapon systems acquisitions.

ACQUIRING AUTOMATED INFORMATION SYSTEMS

Acquiring automated information systems remains a high risk area for the Department. The number of system acquisition, migration, and modification projects is huge. This poses a formidable management challenge, because the DoD track record for automated system development has not been good for many years. Projects have tended to overrun budgets, slip schedules, evade data standardization and interoperability requirements, and shortchange user needs. The huge effort needed to develop an accurate inventory of DoD information systems and their interfaces in order to assess vulnerability to the year 2000 computing problem has underscored the need to revamp the lax management controls that led to the runaway proliferation of systems. Also, recent audits have identified instances where the management controls for vital system development projects did not ensure adequate program definition and structure.

For example, we looked at the acquisition of the Composite Health Care System (CHCS) II. CHCS II will provide world-wide access to computer based patient records. Total program cost is estimated at $1.4 billion. Over an 18-year period, the life-cycle cost estimate will approximate $5.0 billion (FY 1998 then-year dollars). We determined that CHCS II needed to undertake additional actions to complete a project management system. A structure linking financial accountability was needed to

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improve the project manager's ability to evaluate whether program results deviate from the baseline for cost, schedule, performance, and milestone exit criteria. Unlike most large weapon systems program, you could not tell how the program was doing because of the inability to track status or baselines. In addition, the funding visibility of the program was limited because the program office had combined CHCS II funding with sustainment and modernization funding for the CHCS I and other clinical business area automated systems.

COMPLIANCE WITH THE BUY AMERICAN ACT AND THE BERRY AMENDMENT

Report No. 99-023

In 1998, we conducted an audit of the procurement of military clothing and related items in response to a requirement in the National Defense Authorization Act for FY 1998. The Buy American Act (41 U.S.C. 10a) and the Berry Amendment (10 U.S.C. 2441 Note) require contracting officers to determine whether items manufactured in the United States or a qualifying country were available. The audit found that contracting officers at 12 military organizations improperly awarded 16 contracts for military and civilian clothing items, valued at $1.4 million, that were manufactured in China, Pakistan, and the Philippines. Additionally, the Air Force, in a separate review, identified 27 other improper procurements of Chinese-made boots valued at $182,511. The noncompliance with the Buy American Act and the Berry Amendment resulted in 43 potential violations of the Antideficiency Act. Each potential violation of the Antideficiency Act requires a separate investigation to determine if there was a violation and assess accountability. Thus, each investigation can result in more work than the original contract requirement. We recommended that the Director, Defense Procurement, issue guidance to emphasize the requirement to incorporate and enforce the Buy American Act and Berry Amendment provisions and clauses in solicitations and contracts for clothing and related items. The Director issued the policy guidance on March 2, 1999.

SUMMARY

The Office of Inspector General remains supportive of reasonable efforts to streamline and improve the Department's acquisition programs. In that regard, we are committed to sharing with the Department and the Congress

the benefit of our experience in this very complex area as new reform proposals are considered. We remain concerned about suggestions to limit or repeal controls that have been proven effective over time, such as the False Claims Act, the Truth in Negotiations Act, the Cost Accounting Standards, the statute that prohibits contractors from charging unallowable costs, and the Defense Contract Audit Agency. We believe that these controls have been critical to maintaining the Government's ability to adequately protect its interests in the acquisition area.

Many beneficial statutory reforms have occurred already in the acquisition arena. The challenge now is to encourage the Department to identify the underlying cause of remaining problems and initiate appropriate corrective actions. We stand ready to assist the Department and the Congress to move forward and address the challenges in acquisition in ways that will protect the interests of the Department and, ultimately, the taxpayers.