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Defense Contractor Material Management and Accounting Systems

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Mr. Chairman and Members of the Subcommittee:

We are pleased to appear before the Subcommittee to discuss GAO's evaluation of the Department of Defense (DOD) and industry agreement for resolving problems with contractor Material Requirements Planning[1] (MRP) systems.

The Defense Contract Audit Agency (DCAA) has identified several common deficiencies in defense contractor MRP systems that cause noncompliance with existing laws and procurement regulations. Specifically, DCAA audits show that MRP system deficiencies result in inaccurate costs being charged to contracts and billed to the government; improper progress payment requests; and defective pricing.

The Subcommittee has heard many differing opinions about what the problem is, what should be done about the problem, and why the problem exists. Three general themes, however, evolved from the hearings held by this Subcommittee last year. First, MRP systems are widely used in the defense industry and offer substantial benefits to industry and the government. Second, DOD and industry both agree there are problems with the systems that need to be corrected. And, third, MRP systems have not been properly

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[1]Material Requirements Planning is a generic term describing an automated material inventory management system. Such systems are used in manufacturing and material planning and control and are designed to maximize productivity and minimize costs by providing "the right part at the right time" to meet production schedules.

integrated with defense contractor cost accounting systems. We believe the latter point, Mr. Chairman, is the central problem surrounding the use of MRP systems for government contracting purposes.

In response to concerns raised by this Subcommittee, a joint DOD-industry working group developed a list of 10 key elements which must exist for a contractor's system to be acceptable for government contract purposes. In December 1987, the Deputy Assistant Secretary of Defense for Procurement issued the key elements and implementation guidance to the military services and the Defense Logistics Agency for use in evaluating and approving contractor material management and accounting systems. The key elements and implementing guidance were also published in the Federal Register and DOD has received public comments on them.

In February 1988 the Deputy Assistant Secretary directed Administrative Contracting Officers to provide contractors with official notification of the key elements and allow 30 days from that notification for contractors to inform the government whether their systems comply with the elements.

At the request of the Subcommittee, we reviewed the DOD and industry agreement to determine whether the government's interests are protected and whether the agreement would result in compliance with government cost accounting standards,

regulations, and a contractor's disclosed accounting practices. We also looked at the DOD-industry agreement in light of the legislation being considered by this Subcommittee.

Generally, the key elements address the problems that have been linked to MRP systems. The key elements require that for a system to be acceptable, it must be completely documented, auditable, and have adequate internal accounting and administrative controls. The key elements also require that a contractor's system not have any inherent biases that give cost preference to one contract type over another (i.e., fixed-price type vs. cost type), or one customer over another (i.e., government vs. commercial); and, that over a reasonable number of contracts and over a reasonable period of time, there not be any significant differences between cost transfers into and out of a contract.

DCAA, the agency which identified the deficiencies with MRP systems, advised us that the key elements and implementing guidance, if followed, should result in "substantive corrective action."

It is important to point out that, with one exception, the DOD-industry agreement does not change existing regulations. The one area where the agreement deviates from existing regulations[2]

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[2] Federal Acquisition Regulation 45.505-3(f)(2)(ii)

involves the commingling of government and commercial inventory. MRP system efficiency is dependent on commingling of government and commercial material. Both DOD and industry agree commingling is necessary to maximize the benefits which MRP systems offer. Thus, DOD is willing to permit commingling as long as controls exist to protect the government's interest.

While the DOD-industry agreement is a positive step toward resolving MRP problems, we believe that it does not adequately address this Subcommittee's fundamental concern--protecting the government's interest. We also believe additional clarity is needed in the DOD-industry agreement regarding who will audit contractor MRP systems and which contractors are covered by the key elements and implementing guidance.

I will briefly discuss each of these issues.

PROTECTING THE GOVERNMENT'S INTEREST

Our primary concern is that the DOD-industry agreement does not contain adequate safeguards for protecting the government's interests when contracts are awarded to contractors having potentially serious MRP problems. As of December 31, 1987, DCAA was tracking 160 major defense contractors which had MRP systems. DCAA determined that 99 of the contractors had deficiencies or indications of potential deficiencies.

DOD's implementing guidance attempts to protect the government's interest in two ways--(1) by relying on the preaward audit process and contract negotiations to mitigate the impact of system deficiencies and (2) by suspending progress payments. We have concerns about both.

Relying on the audit and negotiation process to protect the government's interest places a heavy burden on DCAA auditors and contracting officers. DCAA's audits and testimony before this Subcommittee show that determining the impact of MRP system deficiencies retroactively is a difficult and massive undertaking.

Our discussions with DCAA auditors and review of DCAA audit reports indicate it is extremely difficult to quantify the financial impact of MRP system deficiencies. It has taken DCAA over three years and some 35 audit reports at one contractor location to identify the adverse financial impact of MRP deficiencies. In view of the difficulty involved, we are skeptical that the preaward audit and contract negotiation process can effectively protect the government's interests prospectively on individual contract awards.

We believe additional safeguards are needed. Such safeguards could include

-- considering a contract type that adequately recognizes the government's risk (e.g., an incentive type contract instead of a firm fixed-price contract);

-- segregating the questionable areas as a cost reimbursable contract line item;

-- reducing a contractor's allowance for profit or fee; or

-- including a contract clause that provides for adjustment of the contract amount after award. Such clauses are commonly called savings or reopener clauses.

DOD procurement regulations were recently revised to include these safeguards for dealing with unacceptable contractor cost estimating systems. Because many of the deficiencies linked to MRP are of a cost estimating nature, we believe the safeguards used for estimating system deficiencies could apply equally to MRP deficiencies. The alternative(s) chosen, of course, should depend upon the risk to the government and consider the severity of the deficiencies, the length of time the deficiencies have gone uncorrected, and the contractor's progress in correcting the problems.

Regarding progress payments, it is unclear what conditions must exist before Administrative Contracting Officers can suspend progress payments. DOD officials have testified before this Subcommittee that existing regulations allow suspensions if a contractor fails to "maintain an accounting system and controls adequate for the proper administration" of progress payments. The DOD-industry agreement seems consistent with the regulations and states that Administrative Contracting Officers will suspend an appropriate percentage on claims for progress payments and public vouchers where contractor systems are not acceptable for government contract costing purposes.

The Deputy Assistant Secretary's February 1988 guidance states that progress payments will be suspended when noncompliance "results in identifiable harm to the government." However, the guidance does not define "identifiable harm" or, more importantly, describe how it will be measured. As indicated earlier, determining the impact of system deficiencies is a difficult and massive undertaking. If progress payment suspensions are dependent on demonstrating measurable "identifiable harm", DCAA and contracting officers face a formidable task.

AUDIT OF CONTRACTOR MRP SYSTEMS

The key elements provide that contractor systems will be subjected to periodic internal audits to ensure the systems are working as expected. We believe the audit requirement should be expanded to also include external audit as well. By external audit we mean audits by public accounting firms and DOD audit organizations.

APPLICATION TO SMALL CONTRACTORS

The key elements were developed to deal with MRP systems, but are written generically for all "material management and accounting systems." This raises concern about whether the key elements will be applied to small manufacturers which do not possess sophisticated MRP systems. In some cases, it may not be cost beneficial for the contractor or the government, to require application of the key elements. Therefore, we believe clarification is needed in the key elements so they are not applied to small manufacturers' systems or in other circumstances neither anticipated nor intended by DOD.

RECENTLY PROPOSED LEGISLATION

The major difference between the proposed legislation and the DOD-industry agreement is the requirement in the legislation for contractors to certify that their systems comply with applicable laws and regulations, standards established by the Secretary of Defense, and disclosed accounting practices.

Regarding the certification requirement, we believe it should not be linked to contractors' certifications of indirect costs as currently provided in the proposed bill. It is unclear how a certification for indirect costs would cover contractors' MRP systems.

Other than the certification requirement, the legislation adopts most of the key elements agreed to by DOD and industry. In some cases, the legislation strengthens and clarifies some of the requirements contained in the DOD-industry agreement. For example, the legislation

-- explicitly addresses the need for DOD audit of contractor systems (an issue we referred to earlier);
-- highlights the need for identifying excess or residual inventory and considering the cost of such inventory in pricing future contracts;
-- deals with the "identifiable harm" issue and recognizes that in some cases contractor systems may be so unreliable that an estimate of adverse financial harm cannot be calculated; and,
-- defines which contractors will be subject to the provisions of the legislation.

Except for linking the certification requirement to indirect cost certification, we support the thrust of the proposed legislation

and believe DOD should revise the key elements and implementation guidance accordingly.

SUMMARY

Mr. Chairman, your Subcommittee has highlighted the complex and technical problems related to MRP systems and provided the impetus for DOD and industry to seek practical solutions. We believe the DOD-industry agreement and proposed legislation are positive steps toward resolving MRP system problems. Further strengthening and clarification, however, is needed in the key elements, implementation guidance, and legislation before they can provide both DOD and industry a proper framework for better understanding the "ground rules" under which contractor MRP systems should operate. Continued vigilance by DOD contracting officers, contract auditors, and DOD management is also necessary to ensure that contractor systems comply with applicable laws and regulations.

Mr. Chairman, that completes my statement. I will be glad to answer any questions you or other members of the Subcommittee may have.