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High-Risk Series

February 1995

Defense Inventory Management



GAO/HR-95-5



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**Comptroller General
of the United States**

February 1995

The President of the Senate
The Speaker of the House of Representatives

In 1990, the General Accounting Office began a special effort to review and report on the federal program areas we considered high risk because they were especially vulnerable to waste, fraud, abuse, and mismanagement. This effort, which has been strongly supported by the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight, brought much needed focus to problems that were costing the government billions of dollars.

In December 1992, we issued a series of reports on the fundamental causes of problems in designated high-risk areas. We are updating the status of our high-risk program in this second series. Our Overview report (GAO/HR-95-1) discusses progress made in many areas, stresses the need for further action to address remaining critical problems, and introduces newly designated high-risk areas. This second series also includes a Quick Reference Guide (GAO/HR-95-2) that covers all 18 high-risk areas we have tracked over the past few years, and separate reports that detail continuing significant problems and resolution actions needed in 10 areas.

This report describes our concerns over the Department of Defense's management of supplies that support the military services. It focuses on the need for the

Department to be more aggressive in changing its management culture through taking advantage of new management practices, technologies, and logistics systems so that inefficiencies can be eliminated and high levels of readiness maintained.

Copies of this report series are being sent to the President, the Republican and Democratic leadership of the Congress, congressional committee chairs and ranking minority members, all other members of the Congress, the Director of the Office of Management and Budget, and the Secretary of Defense.



Charles A. Bowsher
Comptroller General
of the United States





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Overview

The Department of Defense (DOD) uses its secondary inventory—spare and repair parts, clothing, medical supplies, and other support items—to support its operating forces. In September 1993, DOD reported that it had an inventory of \$77.5 billion. We estimate that about \$36.3 billion of the inventory represents items that are not needed to be on hand to support DOD’s war reserve or current operating requirements.¹

The Problem

In 1992, we reported that DOD had wasted billions of dollars on excess supplies and burdened itself with the need to store them.²

The problem resulted from DOD’s culture that believed it was better to overbuy items than to manage with just the amount of stock needed. The culture prevented DOD from using effective inventory management and control techniques and modern commercial inventory management practices that would allow lower inventory levels.

¹The \$77.5 billion and the \$36.3 billion includes inventory that has been revalued to reflect the value of items that need to be repaired and the scrap value of items to be disposed of. We estimate that if all the inventory were valued at its acquisition cost, the values would be \$96.8 billion and \$48.4 billion, respectively.

²High-Risk Series: Defense Inventory Management (GAO/HR-93-12, Dec. 1992).

Progress

To its credit, DOD has achieved some inventory reductions, initiated some pilot projects, and recognized that it must improve its inventory management. However, DOD has made little overall progress in correcting long-standing management problems that perpetuate buying and holding too much inventory. For example, DOD stores billions of dollars of unneeded inventory, requirements continue to be overstated leading to unnecessary procurements, and modern commercial practices are not being implemented as fast as possible.

DOD's inventories and inventory funding levels remain relatively high while the operating forces supported by the inventories have decreased and are projected to continue decreasing.

Two current efforts that potentially affect DOD's inventory management capabilities have experienced problems—the Corporate Information Management (CIM) initiative is suffering from fundamental weaknesses in DOD's implementation strategy, and the Defense Business Operations Fund (DBOF) is not working as DOD had intended.

Outlook for the Future

DOD has had limited success with some commercial inventory practices that have substantially reduced costs while meeting managers' inventory needs. However, DOD still needs to be more aggressive in changing its inventory management culture in order to ensure high levels of readiness within existing resource constraints. DOD also must take advantage of new management practices, technologies, and logistics systems.

DOD's top management needs to be much more attentive to the CIM and DBOF initiatives because they will provide managers with the critical tools needed for managing inventory in the future. DOD must also improve the accuracy of inventory data. Finally, congressional oversight is necessary to maintain DOD's focus on these problems.

Managing DOD's Inventory Presents Challenges

In 1989, DOD's forces included about 2.1 million active duty soldiers, sailors, marines, and airmen; over 2,800 attack and fighter aircraft; about 570 ships; and 18 active Army divisions. To support these forces, DOD had inventories of spare and repair parts, clothing, medical supplies, and other support items. The inventory was valued at about \$92.5 billion, with an acquisition cost of about \$108 billion.

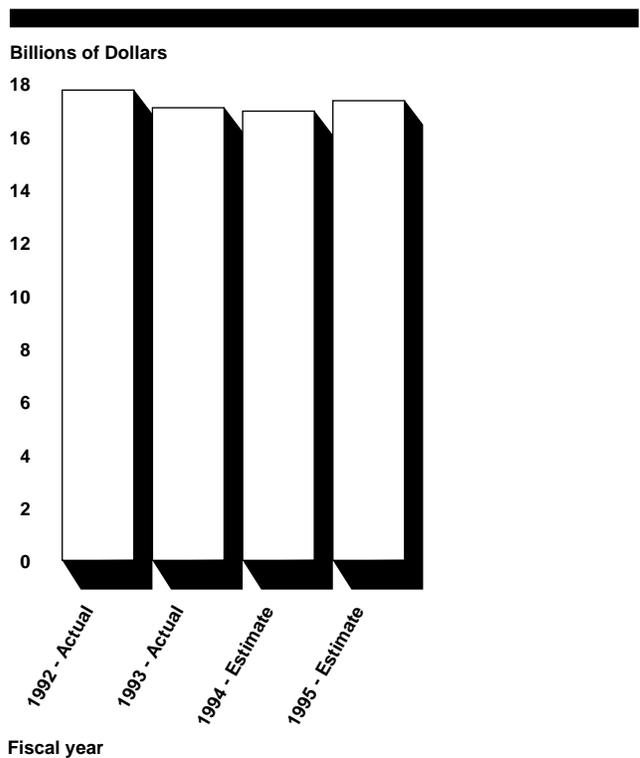
With the collapse of the Soviet Union, DOD altered threat scenarios and began downsizing its forces. By 1993, active duty military personnel had decreased to about 1.7 million; active attack and fighter aircraft to about 2,100; ships to 435; and active Army divisions to 14. DOD projects that its forces will continue to decrease at least through fiscal year 1996. Between 1989 and 1993, the value of DOD's inventory decreased by \$15 billion, to about \$77.5 billion (acquisition cost of about \$96.8 billion).

Notwithstanding the sizable force structure changes since 1989, DOD's inventory funding levels have remained relatively high. To some extent, this reflects Defense Business Operations Fund price increases related to the total cost of doing business. Operations and maintenance funds are the primary

Managing DOD's Inventory Presents Challenges

source of funds for customer inventory purchases. Figure 1 shows actual and estimated operations and maintenance funds to be used for inventory purchases for fiscal years 1992 through 1995.

Figure 1: Operations and Maintenance Appropriations for Inventory (Fiscal Years 1992-95)



Managing DOD's Inventory Presents Challenges

DOD has wasted billions of dollars on excess supplies, burdened itself with the need to store them, and failed to acquire the tools or expertise needed to manage them effectively. DOD frequently overestimated its supply requirements and purchased too much.

The current downsizing environment is posing additional challenges for DOD. In order to ensure that high levels of readiness are achieved, DOD must adopt new management approaches that will allow it to sustain these high levels while dealing with resource constraints. At the same time, DOD must address the large amount of unneeded inventory, currently stored in its warehouses, that will continue to drain resources. This problem will only increase as force reductions continue.

DOD's excessive inventories of unneeded items have resulted largely from a culture that believed it is better to overbuy items than to manage with just the amount of stock needed. This culture has been slow to adopt new management practices, technologies, and logistics systems. DOD has failed to adopt comprehensive inventory management practices in which only those items necessary to support operations are

**Managing DOD's Inventory Presents
Challenges**

stored. DOD has also failed to provide its personnel with the tools and incentives to manage the inventory properly.

A Comprehensive Effort Is Needed to Change DOD's Inventory Management Practices

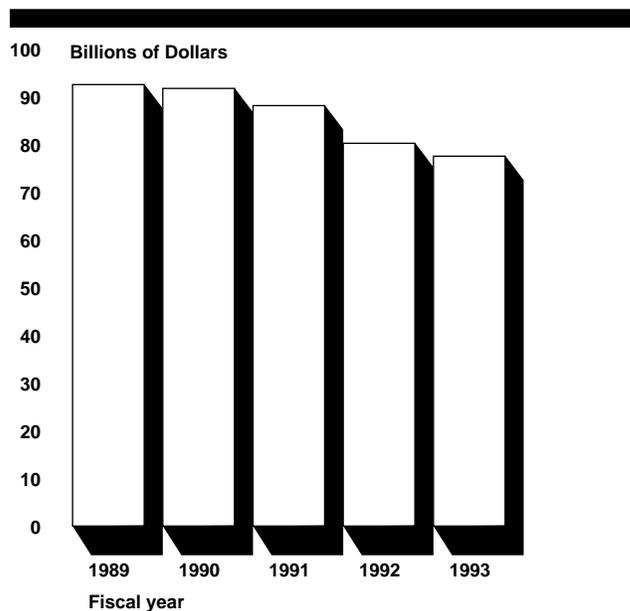
In recent years, DOD has recognized that it must reduce the size and cost of its inventory. However, in spite of a \$15 billion inventory reduction, DOD has yet to achieve effective and efficient inventory management. DOD does not have adequate oversight of its inventory, financial accountability remains weak, requirements continue to be overstated, and DOD can be more aggressive in implementing modern commercial practices. Also, DOD has yet to realize the benefits of initiatives such as DBOF and CIM.

Storing and Maintaining Unneeded Inventory Is Costing DOD Millions

As shown in figure 2, DOD has reduced its inventory from \$92.5 billion in 1989 to \$77.5 billion in 1993.

**A Comprehensive Effort Is Needed to
Change DOD's Inventory Management
Practices**

**Figure 2: DOD's
Inventory** (Fiscal Years
1989-93)

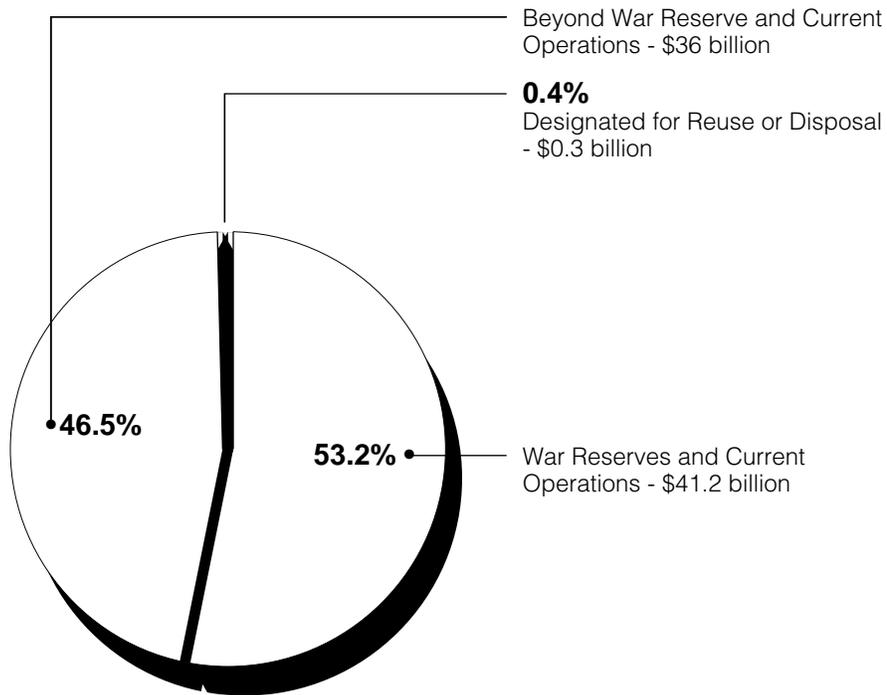


While DOD's inventory reduction represents progress, about half of the \$77.5 billion inventory still is beyond what is needed to be on hand to satisfy war reserve or current operating needs. Included in the \$77.5 billion is about (1) \$36 billion of inventory that is being retained beyond what is needed for war reserves and current operations and (2) \$286 million of inventory that DOD has designated for reuse and disposal and that

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had an acquisition cost of about \$14 billion.
Figure 3 breaks out DOD's inventory.

Figure 3: DOD's Inventory (September 30, 1993)



Note: The inventory designated for reuse or disposal has an acquisition cost of about \$14 billion.

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In September 1994, we reported that for aviation parts, which account for \$39.6 billion of the \$77.5 billion inventory, DOD's proceeds from the sale of commercial-type surplus parts averaged less than 1 percent of the fiscal year 1993 cost. We reported that DOD emphasizes disposing items as quickly as possible. In contrast, the disposal systems of commercial airlines and other private sector companies emphasize maximizing sales proceeds. By providing incentives and training, and by identifying highly marketable parts, DOD could increase its proceeds.

**DOD Is Slow in
Taking Critical
Steps to Change
Culture**

To DOD's credit, it has acknowledged that it must change its inventory management culture. DOD sees training as a key tool that can help achieve this cultural change; however, it still has not taken steps that are essential to most effectively use training to foster the desired change. In August 1994, we reported that:

- DOD has not developed or promulgated written plans and guidance on how to use training to effect its desired cultural change.
- DOD's training courses lack the content and emphasis necessary to foster a new way of thinking about inventory management.

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- Most inventory managers are not receiving the training they need to effect cultural change.

**Adequate
Inventory
Oversight Has
Not Been
Achieved**

Information on the quantity, location, and condition of inventory is necessary for effective and efficient inventory management. We previously reported that because visibility over inventories was not adequate, managers were making improper purchase decisions. Such conditions persist. For example, in May 1994, we reported that Army managers at one base spent nearly \$800,000 to repair items when issuable assets were available in the Army's supply system. In another case, we reported that \$67 million of material ordered for ship overhauls was not used and was not returned to the supply system for use on other overhauls.

DOD's 1994 strategic plans for logistics call for improving asset visibility in such areas as in-transit assets, retail-level stocks, and through implementation of its CIM initiative. DOD's asset visibility plans will not be completely implemented until 1996.

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**Requirements
Continue to Be
Overstated**

In December 1992, we reported that for years DOD had experienced problems in accurately determining how much inventory it needs to buy. Our recent work shows that overstated requirements continue to be a problem.

For instance, in April 1993, we reported that two Army Commands overstated their war reserve requirements by at least \$500 million because the requirements had not been updated and continued to reflect a European war scenario. We also reported that the Commands' current operating requirements were overstated by about \$1 billion because forecasted requirements erroneously included nonrecurring demands and failed to consider items being returned by units.

Improvements can also be made to the Navy and Air Force requirements determination processes. In July 1994, we reported that the Navy's process for determining requirements for material needed by the shipyards was not working as intended. For example, at the end of fiscal year 1993, the Navy's shipyards had about \$35 million of material on hand and another \$12 million of material on order for repairs that had been completed. We also reported that (1) shipyards were holding millions of dollars of material that was not

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recorded on official records, (2) shipyards had inadequate controls over shop store issues, (3) shop store inventories exceeded requirements, and (4) material was not adequately protected.

In April 1994, we reported that the Air Force had significant amounts of invalid back orders, which are considered as requirements in computing stock levels, making procurement and repair decisions, and in developing budgets. We and the Air Force identified over \$209 million of invalid back orders at 17 retail activities. The Air Force subsequently cancelled these orders.

In October 1993, we reported that the Air Force had made progress in terminating excess orders by implementing management information systems that enable command and headquarters management to compare the performance and measure the progress of logistics centers in terminating orders. However, we reported that the Air Force was missing potential terminations because it was using an unjustified 6-month level of stock above item requirements as a buffer in computing termination levels.

On the basis of analyses of programs, budget support documents, and reported

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inefficiencies such as those discussed above, we reported in September 1994 that the military services' operations and maintenance budget requests for fiscal year 1995 could be reduced by \$514 million if the services improved their management of spare and repair parts. The Armed Services Conference Committee subsequently recommended that the budgets be reduced by \$135 million.

**Financial
Accountability
Remains Weak**

DOD continues to lack financial accountability and control over its inventory because it (1) does not have accurate, reliable data to support the quantity, condition, and value of items, and (2) does not have integrated systems to provide accurate data. DOD recognizes these weaknesses and is taking corrective action.

Audit reports on DOD activities prepared to address requirements of the Chief Financial Officers (CFO) Act have continued to show that DOD inventory records are inaccurate. For example, the Army Audit Agency's report on Army's fiscal year 1993 financial operations disclosed that it could not verify over \$12 billion of inventory records. The Army Audit Agency estimated that 51 percent of the inventory records sampled

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had inaccurate information, either in terms of quantity or condition.

Similarly, the Air Force Audit Agency's report on the Air Force's fiscal year 1993 financial operations disclosed that the Air Force's reported inventory of \$6.5 billion was not reliable because of inventory valuation, over and under reporting of quantities, and omissions of relevant inventory data.

With these inventory record accuracy weaknesses DOD cannot ensure that it can meet readiness demands. This readiness impact, as it pertained to Operation Desert Shield/Storm, was highlighted in DOD's fiscal year 1993 Federal Managers' Financial Integrity Act report. That report stated that "significant deficiencies in tracking inventory and maintaining inventory records ... made operational support planning more difficult and were responsible for duplicate orders, backlogs at aerial and sea ports, unnecessary material shipped into the theater, difficulty in prioritizing cargo backlogs, and inefficient intra-theater movement."

In fiscal year 1993 reports, DOD identified a number of actions that are intended to

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correct these fundamental weaknesses. DOD's primary corrective actions include transferring management of its consumable inventory items to a single manager and the development of a single automated system to support item management across the services. These actions are intended to eliminate duplicate databases and reduce the requirement to reconcile inventory records. DOD is also developing a standardized statistical sampling methodology that is to be incorporated into its logistical procedures. This sampling methodology is intended to meet DOD logistical needs for record accuracy, as well as supporting the requirements of the CFO Act. These corrective actions are targeted for completion from fiscal year 1994 through the end of fiscal year 1996.

**Use of
Commercial
Practices Can
Save Millions of
Dollars**

Private sector companies are streamlining their logistics operations by adopting innovative inventory management strategies that reduce costs and improve the quality of service.

As of September 1993, DOD had invested about \$16.5 billion in its food; electronics; construction, general and industrial; and clothing and textile inventories. During the

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past 2 years, we reported that DOD has the potential to save millions of dollars relating to these inventories by adopting commercial inventory management practices. For example:

- DOD buys and stores redundant levels of electronics inventories. Private sector practices, such as long-term relationships with suppliers, direct delivery programs, and direct communications between suppliers and users, have been effective in eliminating intermediate handling and storage locations.
- DOD stores duplicate inventories of construction, general and industrial supplies at wholesale and retail locations. Private sector practices include encouraging direct delivery of supplies to industrial centers by locating suppliers at “supplier parks” near the centers, and streamlining the ordering, bill-paying, and distribution processes through use of electronic data interchange systems.
- DOD’s food supply system encourages large inventories and unnecessary costs because of multiple layers of warehouses. By relying on full-line food service distributors to move food from suppliers to end users, private sector companies avoid the direct costs of holding, handling, and transporting food.

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- DOD stores redundant levels of clothing and textile inventories in its wholesale and retail system. Private sector companies use prime vendors to provide timely and direct delivery between suppliers and customers.

DOD generally agrees that increased use of commercial practices could lower costs and reduce inventories and has taken steps to expand the use of commercial practices. For example, the Defense Logistics Agency (DLA) uses prime vendors for medical supplies at over 140 military hospitals. DLA plans to implement direct vendor delivery practices for half of all sales by fiscal year 1997. DLA also plans to use electronic communications and electronic data interchange for 70 percent of its procurement transactions by fiscal year 1995.

**Benefits of
Recent Initiatives
Have Not Been
Realized**

In 1992, we reported that DOD had begun initiatives that appeared to be steps in the right direction for inventory management. Most of DOD's inventory is now accounted for in DBOF. However, the Fund's operation has been hindered by DOD's inability to correct problems, such as inaccurate financial reports and fragmented and costly accounting systems, that do not provide information needed to control costs.

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The Fund's primary objective is to focus on managing the total costs of carrying out certain critical DOD business operations, including inventory management. The Fund was intended to provide a mechanism through which DOD could adopt a businesslike approach for identifying and reducing operating costs.

In April 1994, we testified that the Fund was not achieving its objective and that DOD needed to complete the following critical actions:

- uniformly implement policies and procedures to provide managers with the necessary guidance to execute day-to-day operations,
- select and implement systems to account for Fund resources, and
- improve the accuracy of monthly financial reports that provide information on the results of business area operations.

We further testified that periodic assessments were critical for determining if problems were being corrected in a timely manner.

In addition, in June 1994, the DOD Inspector General reported that he was unable to

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express an opinion on DBOF's Statement of Financial Position because of material internal control weaknesses and significant deficiencies in the Fund's accounting systems, that prevented the preparation of accurate financial statements.

In 1992, we also reported that DOD planned to use its CIM initiative to simplify or reengineer the military services' distribution systems and standardize computer systems in functional areas such as logistics. DOD projected savings of about \$18 billion through improvements to its materiel management business processes.

In October 1994, we reported that the CIM initiative has had little effect on materiel management business practices. DOD had focused on selecting standard logistics information systems—called migration systems—that the services and DLA are to implement by mid-1997. As a result, business process reengineering efforts (where most savings occur) may be delayed several years.

We reported that although some progress had been made, several impediments have delayed the first steps in the reengineering process. Three critical impediments are (1) some DOD managers in the services and

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DLA have not fully accepted the initiative, (2) DOD has not integrated its various corporate information management efforts, and (3) initiative management authority is unclear because of confusing DOD guidance. For example, until April 1994 DOD had not developed a mechanism to handle cross-functional issues.

We also reported that DOD had not devised a management strategy to encourage the active participation and leadership of functional managers, particularly the service Chiefs of Staff and the DLA Director, and had not ensured that its employees understand the initiative objectives and implementation strategies. As a result, DOD has not made the cultural changes needed to successfully implement the initiative.

Taking Further Action

In 1992, we reported that major changes were needed in all levels of DOD's inventory management system. We reported that top management needed to take long-range actions to (1) change the organizational culture to eliminate the overstocking of items, (2) increase the use of commercial practices, (3) put in place and monitor improved performance measures that stress cost-effectiveness and inventory reduction, and (4) improve the computer systems used in inventory management.

Although we have seen pockets of improvement, DOD has made little overall progress in implementing the long-range actions necessary to effectively and economically manage its inventory. In order to ensure required readiness levels and to make the most efficient and effective use of available financial resources, DOD management needs to commit itself to ensuring that its inventory management culture stresses providing its forces with necessary supplies when they are needed. This means that DOD must not burden the supply system with the management problems and costs associated with accumulating, storing, and maintaining large unneeded inventories.

Taking Further Action

Further, DOD needs to move aggressively to identify and implement viable commercial inventory management practices for supplying its forces. DOD management should demonstrate its commitment to changing its culture by implementing performance measures that stress cultural change toward cost-effective inventory management, and by providing its managers with the automated accounting and management systems necessary to achieve these objectives.

In this regard, DOD needs to move forward in an aggressive manner with its DBOF and CIM initiatives. For these initiatives to be successful, the Secretary of Defense needs to (1) ensure that Fund problems are corrected in a timely manner, and (2) DOD's top managers are actively involved and supportive of both efforts.

The corrective actions recommended above will not significantly alter DOD's ineffective and inefficient inventory management practices for several years. As previously reported, DOD can realize savings now by

- committing to improved inventory management through top management emphasizing (1) inventory indicators such as those that highlight reduction and disposal

Taking Further Action

- of unneeded inventory, (2) the implementation of efficient and effective inventory management practices, and (3) training personnel in those practices,
- improving the accuracy of data used to determine procurement requirements, including the accuracy of data on the quantity, condition, and value of inventory items managed through existing logistics and financial systems, and
 - directing the military components to aggressively enforce existing policies and procedures that will minimize unnecessary acquisition of inventory, such as the elimination of invalid back orders.

In addition, past inefficiencies coupled with reductions in DOD's force structure have resulted in billions of dollars of inventory that is not needed to support current operations. To minimize its inventory storage costs, DOD needs to aggressively identify and dispose of those stocks that have little potential for future use. In this regard, DOD should explore ways to maximize its return on items being disposed of by exploring commercial marketing techniques that would improve DOD's return.

Taking Further Action

Close congressional oversight of DOD's inventory management remains critical to sustaining and accelerating improvements.

Related GAO Products

Defense Management: Impediments Jeopardize Logistics Corporate Information Management (GAO/NSIAD-95-28, Oct. 21, 1994).

Commercial Practices: Opportunities Exist to Enhance DOD's Sales of Surplus Aircraft Parts (GAO/NSIAD-94-189, Sept. 23, 1994).

1995 Budget: Potential Reductions to the Operations and Maintenance Programs (GAO/NSIAD-94-246BR, Sept. 6, 1994).

Organizational Culture: Use of Training to Help Change DOD Inventory Management Culture (GAO/NSIAD-94-193, Aug. 30, 1994).

Army Inventory: Unfilled War Reserve Requirements Could Be Met With Items From Other Inventory (GAO/NSIAD-94-207, Aug. 25, 1994).

Defense Inventory: Changes in DOD's Inventory, 1989-93 (GAO/NSIAD-94-235, Aug. 17, 1994).

Navy Supply: Improved Material Management Can Reduce Shipyard Costs (GAO/NSIAD-94-181, July 27, 1994).

Related GAO Products

Partnerships: Customer-Supplier Relationships Can Be Improved Through Partnering (GAO/NSIAD-94-173, July 19, 1994).

Commercial Practices: DOD Could Reduce Electronics Inventories by Using Private Sector Techniques (GAO/NSIAD-94-110, June 29, 1994).

Defense Business Operations Fund: Improved Pricing Practices and Financial Reports Are Needed to Set Accurate Prices (GAO/AIMD-94-132, June 22, 1994).

Army Inventory: Opportunities Exist for Additional Reductions to Retail Level Inventories (GAO/NSIAD-94-129, June 6, 1994).

Army Inventory: More Effective Review of Proposed Inventory Buys Could Reduce Unneeded Procurement (GAO/NSIAD-94-130, June 2, 1994).

Army Inventory: Changes to Stock Funding Repairables Would Save Operations and Maintenance Funds (GAO/NSIAD-94-131, May 31, 1994).

Air Force Logistics: Improved Backorder Validation Procedures Will Save Millions (GAO/NSIAD-94-103, Apr. 20, 1994).

Related GAO Products

Defense Management Initiatives: Limited Progress in Implementing Management Improvement Initiatives (GAO/T-AIMD-94-105, Apr. 14, 1994).

Commercial Practices: Leading-Edge Practices Can Help DOD Better Manage Clothing and Textile Stocks (GAO/NSIAD-94-64, Apr. 13, 1994).

Defense Management: Stronger Support Needed for Corporate Information Management Initiative to Succeed (GAO/AIMD/NSIAD-94-101, Apr. 12, 1994).

Financial Management: DOD's Efforts to Improve Operations of the Defense Business Operations Fund (GAO/T-AIMD/NSIAD-94-146, Mar. 24, 1994).

Defense Inventory: Changes in DOD's Inventory Reporting, 1989-1992 (GAO/NSIAD-94-112, Feb. 10, 1994).

Air Force Logistics: Some Progress, But Further Efforts Needed to Terminate Excess Orders (GAO/NSIAD-94-3, Oct. 13, 1993).

Defense Inventory: More Accurate Reporting Categories Are Needed (GAO/NSIAD-93-31, Aug. 12, 1993).

Related GAO Products

Defense Inventory: Applying Commercial Purchasing Practices Should Help Reduce Supply Costs (GAO/NSIAD-93-112, Aug. 6, 1993).

Property Disposal: DOD Is Handling Large Amounts of Excess Property in Europe (GAO/NSIAD-93-195, July 30, 1993).

Financial Management: Opportunities to Strengthen Management of the Defense Business Operations Fund (GAO/T-AFMD-93-6, June 16, 1993).

Commercial Practices: DOD Could Save Millions by Reducing Maintenance and Repair Inventories (GAO/NSIAD-93-155, June 7, 1993).

DOD Food Inventory: Using Private Sector Practices Can Reduce Costs and Eliminate Problems (GAO/NSIAD-93-110, June 4, 1993).

Army Inventory: Current Operating and War Reserve Requirements Can Be Reduced (GAO/NSIAD-93-119, Apr. 14, 1993).

Defense Inventory: Defense Logistics Agency's Material Returns Program (GAO/NSIAD-93-124, Mar. 30, 1993).

Related GAO Products

Navy Supply: Improved Backorder Management Will Reduce Material Costs
(GAO/NSIAD-93-131, Mar. 19, 1993).

Financial Management: Poor Internal Control Has Led to Increased Maintenance Costs and Deterioration of Equipment
(GAO/AFMD-93-8, Jan. 25, 1993).

Air Force Requirements: Cost of Buying Aircraft Consumable Items Can Be Reduced by Millions (GAO/NSIAD-93-38, Nov. 18, 1992).

Defense Logistics Agency: Why Retention of Unneeded Supplies Persists (GAO/NSIAD-93-29, Nov. 4, 1992).

Army Inventory: Divisions' Authorized Levels of Demand-Based Items Can Be Reduced (GAO/NSIAD-93-09, Oct. 20, 1992).

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