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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

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BEST DOCUMENT AVAILABLE

The Honorable
The Secretary of Defense

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Attention: Assistant Secretary of Defense
(Comptroller)

Dear Mr. Secretary:

We examined progress payments made by the Department of the Army to the Bell Helicopter Company, Fort Worth, Texas, during performance of Bell's fixed-price and fixed-price-incentive contracts for military helicopters. We examined also Bell's reports that compare payments with costs incurred plus profits for helicopters delivered under its incentive contracts.

On June 30, 1971, Bell held defense contracts valued at about $1.8 billion. The U.S. Army Aviation Systems Command (AVSCOM), St. Louis, Missouri, is responsible for the administration of these contracts, which is handled primarily by Army personnel located at the Bell plant--identified as Army Bell Plant Activity (ABPA) personnel. A resident staff of the Defense Contract Audit Agency (DCAA) is also stationed at the Bell plant.

Our examination showed that Bell had received additional amounts as progress payments because it had (1) included in the cost of work in process estimated and anticipated costs rather than costs actually incurred and (2) understated costs applicable to delivered items for which it had already been paid the contract price. In addition, we found that Bell had retained payments for delivered items in excess of amounts provided by the contract.

These additional payments will be offset as other costs are incurred or when the contracts are settled. In the interim, however, Bell has had interest-free use of Government funds. We did not compute the interest on the overpayments because the amounts varied from day to day as costs were incurred. The amounts would be substantial, however, as indicated by the following specific examples.

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PROGRESS PAYMENTS BASED ON ESTIMATED INSTEAD OF INCURRED COSTS

The Armed Services Procurement Regulation (ASPR) states that progress payments based on costs will be made only for incurred costs identified to specific contracts. It defines "incurred costs" as costs of direct labor, material, and services identified with and necessary for the performance of the contract and all allowable overhead (indirect costs).

Our examination of 154 progress payment requests applicable to a number of contracts showed that Bell had used estimates of costs as well as incurred costs in computing the amounts claimed for progress payments. For 36 of the 154 requests, the use of estimated costs resulted in overpayments ranging from $22,000 to $2.6 million.

Costs estimated to facilitate early preparation of progress payment requests

Bell prepares a monthly Contract Cost Status Report which shows total contract costs and weekly reports which show labor, material, and overhead costs incurred. These reports, which provided the basic support for the progress payment requests, were not available until several days after the end of the period for which they were prepared. Therefore a progress payment request based on these costs would have to be delayed for several days after the close of the cost period. To avoid this delay, Bell prepared progress payment requests on the basis of the costs shown by the available cost reports plus estimates of costs incurred for the period covered by the reports in process.

Bell prepared also progress payment requests prior to the end of the period for which costs were claimed. This necessitated estimating costs to be incurred as well as costs incurred but not reported. For example, a progress payment request was submitted on January 18, 1971, on the basis of costs projected through January 23, 1971. This request was paid by the Army on January 21, 1971, 2 days before the end of the period for which costs were claimed.

In December 1970 we informed ABPA personnel that we had found instances of overpayments resulting from Bell's use of estimates in its progress payment requests. In April 1971 ABPA personnel informed Bell that no estimates were to be included in such requests; however, in June 1971 Bell was still using estimates. Progress payment requests under seven contracts submitted by Bell on June 25, 1971, included costs through June 25, 1971.

Since the weekly cost reports, showing incurred costs for the week ended June 25, 1971, were not available until June 30, 1971, the costs for this week were based on estimates. ABPA personnel had approved these requests prior to our review. They attempted to stop payment after we notified them that the requests were based, in part, on estimated costs. However, only one progress payment request for $2,422,828 was returned to Bell with instructions that estimated costs be eliminated and that only allowable incurred costs be claimed. A revised claim was submitted for $1,692,550. This resulted in a reduced payment to Bell of $730,278.

Material costs estimated

Bell estimated its costs for several cost elements because its cost accounting system did not provide for precise identification of contract costs. For example, for some raw materials used on production contracts for one helicopter model, Bell estimated monthly, by contract, the costs of total requirements that should have been purchased and on hand at various intervals during production. The estimated value of these materials was included in progress payment requests as costs incurred for material requirements.

Bell's practices did not provide for identification of these material charges to purchase orders, receipts, or other evidence that the material was on hand and applicable to the contract being charged. Material purchases were identified as contractor-owned inventory and were commingled with commercial stocks as well as with materials acquired for other Government contracts.

We discussed this matter with ABPA personnel who informed Bell that the procedures for claiming these costs on progress payments were unacceptable. The ABPA personnel, however, have continued to allow Bell to estimate material costs on the basis of Bell's promise to begin developing a new approach to the treatment of material costs. During the past several years, Bell has made similar commitments to correct this situation and to date has not taken corrective action.

Defense Procurement Circular No. 94, effective for contract solicitations and for additions of new items of work after January 1, 1972, revises requirements for eligibility of material costs for progress payments. One significant change provides that materials purchased directly for a contract be eligible for progress payments only after payment for the materials has been made. Costs incurred but not necessarily paid, however, can be claimed for materials in contractor-owned inventory that have been withdrawn for use under a contract. Since Bell purchases the materials discussed above for its inventory rather than directly for a contract, this new requirement may not affect Bell's progress payments which include cost estimates.

Army previously notified of deficiencies by DCAA

DCAA considers many elements of Bell's accounting and material control system to be deficient. A May 15, 1970, report to the Commanding General of AVSCOM contained the following statement.

> "*** Certain important areas of the contractor's accounting and material control system are not adequate to assure reasonably accurate interim costing to and among the various concurrent Government production contracts. In our opinion, the system does not provide for reliable segregation and accumulation of contract costs necessary for the proper administration of progress payments as required by ASPR ***."

As a result of this report and the findings of a July 1970 Army "Should Cost" team report, AVSCOM negotiated certain agreements with Bell in an attempt to correct some of the deficiencies. AVSCOM signed the agreements before receiving DCAA's comments on the adequacy of the proposed corrective actions. DCAA has since stated that the agreements, for the most part, ignore the questionable features of the contractor's system that affect progress payments.

OVERSTATEMENT OF THE COST OF WORK IN PROCESS INCREASES PROGRESS PAYMENTS

The amount of outstanding progress payments is limited, in part, to a specified percentage of costs incurred for work in process. ASPR states that the cost of work in process is the difference between the total costs incurred and the costs incurred applicable to items delivered, invoiced, and accepted.

ASPR provides that the costs incurred for items delivered, invoiced, and accepted, in order of preference, be computed on the basis of (1) the actual unit costs of items delivered, giving proper consideration to the deferment of the starting-load costs, (2) the projected unit costs (based on experienced costs, plus estimated costs to complete the contract) if the contractor maintains cost data which will clearly establish the reliability of such estimates, and (3) the total contract price of items delivered.

Although Bell used method (2) in preparing other statements, none of these methods were used in preparing progress payment requests. Rather, Bell computed costs incurred applicable to work in process on the basis of the total contract costs incurred less the proportionate amount of the contract price adjusted to eliminate profits (target costs) for items delivered. This procedure, however, fails to allocate to the costs of items delivered any variance between target costs and experienced costs. In the case of cost overruns, this method increases the amounts of progress payments since the work in process includes the cost overruns for both work in process and items delivered.

As a result, on one fixed-price contract which was experiencing a substantial cost overrun, Bell received about $15 million more in progress payments than it would have received if the amount of cost overrun had been apportioned between work in process and delivered items. When we brought this matter to the attention of ABPA personnel, all progress payments on this contract were stopped and action was started to obtain refund of the overpayment. On March 20, 1972, Bell refunded the amount of overpayment--$14,534,935.

We asked the ABPA personnel to review all other contracts with Bell to determine the amounts, if any, that may have been paid in excess of limitations. This review was under way at the time we completed our work.

UNALLOWABLE COST INCLUDED IN THE COST OF DELIVERED ITEMS

Bell is required by provisions in its incentive contracts to compare, on a quarterly basis, costs incurred plus profits for delivered items with the amounts received for delivered items (target prices). If the amounts received exceed costs incurred plus profits (which may occur in instances of cost underruns), the excess is to be immediately refunded to the Government.

The cost incurred, as shown by Bell's records, included certain items that are not allowable under Government contracts. To arrive at the allowable incurred costs for delivered items, provision must be made to eliminate the unallowable costs from the total recorded costs. Our review of the quarterly comparisons for 12 contracts disclosed that Bell's method of estimating the amounts of unallowable costs included in recorded costs had resulted in an understatement of unallowable costs and in an overstatement of the costs of delivered items used in the quarterly comparisons. Such overstatements allowed Bell to retain about $1.6 million in contract payments in excess of the amounts authorized.

For example, for the quarter ended March 31, 1971, Bell refunded about $79,000 for one contract. In preparing this quarterly comparison, unallowable costs were estimated at $1.7 million. This amount, however, was considerably less than the actual amount of $2.4 million of unallowable costs that was applicable solely to general and administrative (G&A) and independent research and development (IR&D) costs, computed in accordance with an agreement between the Army and Bell. This agreement provided that specified percentages of recorded G&A and IR&D costs be considered unallowable for Government contracts. Had Bell reduced the recorded costs of delivered items for this contract by $2.4 million rather than $1.7 million, the refund due the Government, after adjustments for profits, would have been $902,000 rather than $79,000, or an increase of about $823,000.

We informed ABPA personnel that Bell was overstating the costs applicable to delivered items in making the required quarterly comparisons of payments received with costs incurred plus profits for delivered items. ABPA personnel, in response, requested Bell on May 10, 1971, to develop a plan of action to correct the costs being used for these comparisons. Bell replied on May 13, 1971, that the computation of unallowable costs was satisfactory.

We again brought this matter to the attention of ABPA personnel on December 13, 1971. ABPA then notified Bell on December 17, 1971, that the method used to estimate the amounts of unallowable costs was not in accordance with existing agreements and that immediate action should be taken to correct this situation. Our review of quarterly comparisons submitted in March 1972 showed that Bell had begun using an acceptable method of estimating the amounts of unallowable costs included in recorded costs.

RECOMMENDATION

We recommend that your Department take actions to

--prevent future overpayments to Bell,

--determine the amounts of and recover past overpayments still outstanding, and

--determine whether the Government is entitled to interest on overpayments to Bell resulting from Bell's erroneous reporting of costs incurred.

We shall appreciate receiving your comments on these matters. If you desire, we shall be pleased to furnish any additional information we may have on this review.

Copies of this letter are being sent to the Director, Office of Management and Budget, and to the Secretary of the Army.

Sincerely yours,

R W Gutmann

Director, Procurement and Systems Acquisition Division