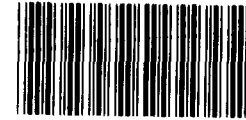




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UNITED STATES GENERAL ACCOUNTING OFFICE
REGIONAL OFFICE
SUITE 1907, 100 SUMMER STREET
BOSTON, MASSACHUSETTS 02110

December 1, 1981



117081

Colonel Charles E. Wheeler, USAF
Commander
Defense Contract Administration
Services Region, Boston
666 Summer Street
Boston, Massachusetts 02210

Dear Colonel Wheeler:

We have completed our examination of selected provisional payments under contracts administered by the Defense Contract Administration Services Region (DCASR), Boston. This letter summarizes the results of our examination which we previously discussed with you. Details of our findings are contained in the enclosure.

Our examination of specific contract payment vouchers disclosed instances in which:

- contract reserves were not withheld or improperly withheld;
- subcontract and consultant labor costs were improperly billed;
- costs were improperly billed before they were paid;
- facilities cost of money was improperly billed;
- general and administrative costs were improperly allocated to facilities cost of money;
- costs were improperly billed before they were incurred;
- precontract costs were improperly billed; and,
- subcontract labor was misclassified and billed as direct material.

In conducting our work, we visited your regional office in Boston and your management area offices in Boston and Hartford to examine the procedures and controls related to provisional approval of contractor reimbursement vouchers. We met with responsible officials and reviewed regulations and supporting documentation pertinent to payments on the contracts we reviewed. We also visited offices of the Defense Contract Audit Agency (DCAA) to examine the procedures related to provisional approval by DCAA of the contractor reimbursement vouchers and to discuss the results of our examinations as it related to DCAA.

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We visited 13 contractors to examine supporting documentation for selected vouchers billed to the Government. Since our selection of contracts was based on a judgement sample, the results of our examination cannot be projected over other cost type contracts administered by DCASR Boston. As of September 30, 1981, DCASR, Boston was administering 5,079 cost-type contracts valued at about \$14.0 billion under which provisional payments were authorized. As discrepancies were disclosed, we brought them to the attention of your Administrative Contracting Officers (ACO) or the DCAA auditors responsible for approval of the vouchers to take action as necessary in the specific instances.

On cost-type contracts, and fixed-price contracts with reimbursement features, many contractor billings are provisionally approved and paid subject to later audit by DCAA. Depending on how the contracts are written, the billings may be approved by either DCASR or DCAA; but, in either case, the ACO is responsible for assuring the reasonableness of costs incurred and should review paid vouchers to ensure the adequacy of the contractors' overall contract management, cost control, and performance. To fulfill their responsibilities, ACOs rely heavily on the contractors' integrity and the reserved right of post audit to protect the Government's interest.

As stated earlier, we discussed our findings with you and members of your staff, and with the DCAA auditors throughout the period of our review. There appears to be general agreement with the findings and we noted that action is being taken to correct the discrepancies. It was also agreed that these findings could have been disclosed by either closer voucher examination in relation to contract terms or mathematical checks or specific voucher audit.

We consider the regulations and policy guidelines which govern DCAS and DCAA administrative and audit responsibilities to be adequate. However, as indicated by our examination, weaknesses do exist in actual practice. We believe that if the ACOs and DCAA auditors exercise greater care in discharging their responsibilities many of the weaknesses would be eliminated.

Both you and DCAA officials expressed concern that because of your present work loads it would be necessary to first determine the cost benefit of any shift from the current management by exception and comprehensive systems and cost review approach to a more specific voucher review. We believe that your concern is valid.

We were advised that you plan to distribute these findings within DCASR, Boston to inform your administrative and financial officials of potential control problems. Accordingly, we are not making any formal recommendations. However, our Washington office plans to distribute copies of this report to

the Assistant Secretary of Defense (Review and Oversight) and to Headquarters, DCAS, Cameron Station, for a "lessons learned" document and for follow-up of corrective actions and cost recoveries taken as a direct result of these findings. If you have any further questions, we will be available to discuss them with you.

We appreciate the cooperation that all the DCAS and DCAA officials extended to our representatives.

Very truly yours,

David P. Sorando
David P. Sorando
Regional Manager

Encl: as stated

Review of Procedures and Controls Related to
Provisional Approval of Contractors'
Reimbursement Vouchers Under DOD Cost-Type Contracts

INTRODUCTION

This review was initiated because a previous GAO review indicated weaknesses in the procedures and controls related to provisional approval of contractor reimbursement vouchers. In order to test the adequacy of controls over provisional payments and the accuracy of contractor billings, we selected thirteen contracts in the Boston region and audited the costs claimed on selected provisional payments. We selected the contracts based on a judgment sample from both active and closed cost-type and time and material contracts administered by DCASR Boston as of April 1981.

REVIEW RESULTS

We found in our examination of specific contract payment vouchers instances in which:

- contract reserves were not withheld or improperly withheld;
- subcontract and consultant labor costs were improperly billed;
- costs were improperly billed before they were paid;
- facilities cost of money was improperly billed;
- general and administrative costs were improperly allocated to facilities cost of money;
- costs were improperly billed before they were incurred;
- precontract costs were improperly billed; and
- subcontract labor was misclassified and billed as direct material.

The results of our examination can not be projected over other cost type contracts administered by DCASR Boston because of the nature of the sample.

However, we believe that these results could be indicative of more problems in the processing of public vouchers.

Improper withholding of contract reserves
resulted in early payment by the Government

We found that a contractor did not withhold \$50,000 for a contract reserve, as required by contract provisions. Another contractor improperly withheld contract reserves and received \$106,164 sooner than it should have.

Software Technology Company (SofTech)
Waltham, Massachusetts

SofTech was awarded time and material (T&M) contract N00039-79-C-0284, subsequently changed to N00024-80-C-7198, on May 18, 1979, for \$3,329,560 (as modified) by the Naval Electronic Systems Command, Washington, D.C., to provide technical services in support of computer software development and maintenance. SofTech has billed and received \$2,542,887 through June 26, 1981, under 33 public vouchers.

SofTech was not providing for the 5 percent contract reserve from the amounts billed to the Government as required by the contract payments clause (DAR 7-901.6). The reserve provision requires a five percent withholding from each payment up to a contract maximum of \$50,000 to ensure the contractor discharges the Government from all liabilities, obligations and claims arising from the contract at the time of final payment. DCAA provisionally approved the vouchers without exception, and DCASR Boston processed and paid the full amount of the vouchers without making provisions for the withholding. The ACO failed to detect the discrepancy until June, 1981.

We discussed this matter with the ACO and he stated that the lack of withholdings was discovered in June 1981 when the contract was reviewed in

connection with a request by the Procurement Office to negotiate an additional option year. The ACO stated that he had notified SofTech verbally of the withholding requirement and instructed the contractor to submit subsequent billings through him for approval. According to a DCASR official the \$50,000 reserve will be withheld from the contractor's current voucher.

Analysis and Technology, Inc. (A&T)
North Stonington, Connecticut

A&T was awarded T&M contract N00140-80-D-6369 delivery order 0003 on July 29, 1980, by the Naval Underwater Systems Center, Newport, Rhode Island to provide engineering and technical services in support of the RANGER 1-80 program.

A&T was withholding only a 0.5 percent contract reserve from the amounts billed to the Government under this delivery order instead of the 5 percent required by the contract payments clause. At the time of our review, A&T had withheld \$938.75 through February 26, 1981, (voucher 9) as a contract reserve, instead of \$9,387.45. A&T was paid the difference, \$8,448.70 by the Government. We brought this matter to the attention of A&T's Vice-President for Finance and Administration who then submitted voucher 10, withholding the proper amount of contract reserve to date, which in effect returned the \$8,448.70 to the Government.

The A&T official informed us that he had requested the Contracting Officer on June 30, 1981 to change the withholding rate from 5 to 0.5 percent on this and other T&M contracts. He said that A&T withheld at 0.5 percent on these contracts because the contract reserve rate had been 0.5 percent on prior contracts, and that when this series of contracts was negotiated, A&T missed the change to 5 percent.

We expanded our review and found that A&T withheld a 0.5 percent contract reserve instead of the 5 percent contract reserve required by the payments clause for various other delivery orders under this and five other T&M contracts. As a result, the contractor received \$43,972 from the Government sooner than it should have. Subsequently, the Contracting Officer modified the payments clauses of four of these contracts changing the amount to be withheld to 0.5 percent. For the four contracts this represented \$35,905 of the \$43,972. Apart from this, we found that A&T had under withheld, and been paid, an additional \$62,192 on other delivery orders under these contracts. However, prior to our review, A&T returned these funds to the Government. Overall, A&T had been paid \$106,164 sooner than it should have been.

DCAA representatives told us that they did not detect the error in the withholding when approving the vouchers for payment. We feel that the error would have been detected had the rate been compared to what was required by the contracts.

Because of the large number of delivery orders and the varying periods involved, we did not compute the impact of the interest costs involved for the Government to pay these monies to the contractor sooner than required.

Improper billing of subcontracted
consultant labor resulted in excess
profits being paid to the contractor

The contractor improperly billed the Government for subcontracted consultant labor after increasing these costs to reflect recovery of general and administrative expenses (G&A) and profit.

Software Technology Company

SofTech awarded three subcontracts under T&M contract N00039-79-C-0284 for consultant labor at various times between July, 1980 and January, 1981.

Until January, 1981, SofTech billed these costs to the Government as other direct costs absorbing only G&A expenses. Beginning in February 1981 and through June 1981, SofTech changed its billing practice, and billed these costs at wage rates, negotiated with the Government, which reflected recovery of G&A and profit. For example, if the subcontract consultant labor cost was \$40 per hour vs. a negotiated wage rate of \$53.63 for SofTech's own system consultant, \$53.63 would be billed, rather than \$47.20 which would allow for recovery of G&A (18 percent) expenses. During the period January-June 1981, SofTech billed the Government for about \$135,000, which exceeded the actual subcontract consultant labor costs and applicable G&A expenses of about \$114,200. The difference of \$20,800, we believe, amounts to excess profits to SofTech.

We discussed this matter with a SofTech official who informed us that SofTech had obtained verbal authorization from a Procurement Office official to bill the Government for subcontract consultant labor by the SofTech labor category most indicative of the overall skills and expertise provided to the program. Prior to January 1981, according to the official, subcontract consultant labor was not considered significant, however, this effort was continuing to expand. SofTech officials believed the company should be allowed to recover its cost and make a profit since the consultant labor services were replacing its own effort, and it would cost the Government more if SofTech had to hire employees to provide the same services.

We discussed this matter with a responsible official of the Procurement Office involved with the authorization. The official stated that there was no provision in the contract for consultant labor and believed, through discussion with SofTech officials, that the subcontract consultant labor was of

limited duration. The official stated that had the Procurement Office been aware of all the details, specific contract provisions would have been negotiated.

We then discussed the matter with the responsible ACO, who was not aware of the agreement between SofTech and the Procurement Office. The ACO stated that SofTech's current proposal for extending the contract effort contained a similar provision, and he requested DCAA to review the proposal. DCAA's review indicated that the accounting practice was unacceptable because it may permit the company to realize excessive profits. The ACO stated that DCAA will be requested to review previous cost billed by SofTech for subcontract consultant labor. The ACO stated that if excess profits are involved, he will take the necessary recovery action.

Improper billing of cost before actual
payment by the contractor resulted in
early payment by the Government

The contractor was billing the Government for costs incurred but not paid. As a result, the contractor received early payment of about \$31,000. In a related issue, the contractor was paid approximately \$170,000 by the Government over a 7 month period for costs which were not yet paid to a vendor because of a dispute.

Dynamics Research Corporation (DRC)
Wilmington, Massachusetts

DRC was awarded cost plus fixed fee (CPFF) contract N00030-81-C-0045 on October 1, 1980 for \$4,716,762 by the Navy's Strategic Systems Project Office, Washington, D.C., to provide maintenance, modification and continuous update of various components of the Polaris, Poseidon and Trident Systems.

Our examination of about \$31,000 of submitted cost for reimbursement under several vouchers disclosed that DRC consistently billed the Government

for cost incurred but not paid. The contract clause entitled, "Allowable Cost, Fixed Fee, and Payment (DAR 7-203.4a)" requires the costs to be paid before they are billed.

In addition, we found that DRC billed the Government during a 7-month period for computer rental costs which were under dispute between DRC and its vendor. During the period January-July 1981, DRC accumulated outstanding disputed costs of \$563,585. Our discussion with a DRC official disclosed that approximately 30 percent, or about \$170,000, was charged directly to this contract. The official stated that reimbursement was requested from and paid by the Government during the period. The official further stated that several other Government cost-type contracts were charged and billed for a portion of the remaining \$563,585 during the same period. The dispute between DRC and its vendor was resolved in July 1981 and DRC made a first payment of \$96,025 to the vendor. Under an agreed upon payments schedule all payments will be made to the vendor by December, 1981.

We discussed with the DRC official the issue of billing the Government before making the actual payment to the vendor. The official stated that DRC's accounting system, approved by the Government is an accrual based system and billings are prepared on that basis. DRC does not reconcile its cash payments to its vendor's accounts payable when preparing vouchers for payment by the Government. According to the official, no one has raised a question before as to its method of billing and until and unless directed otherwise, the company will continue billing on the same basis. The rationale, the official stated, was that DRC has incurred a liability for effort under the contract which has to be paid.

We brought the issues to the attention of the ACO responsible for administering the contract. The ACO stated that the matter would be reviewed with

the assistance of DCAA and, if appropriate, action would be taken to recover the money and/or DRC would be charged interest. In addition, DRC would be directed to the proper billing procedure under the contract payments provision.

Improper billing of facilities cost
of money resulted in overpayments
to the contractor

The contractor billed the Government for facilities cost of money based on estimated costs over the period of performance rather than on the basis of direct labor costs incurred, resulting in overpayments of \$110,252.

Simplex Wire and Cable Co. (Simplex)
Portsmouth, New Hampshire

Simplex was awarded CPFF contract N00039-78-C-0120 for cable on January 31, 1978 for \$11,802,508 (as modified) by the Naval Electronic Systems Command, Washington, D.C.

Our examination disclosed that simplex improperly billed and was paid \$110,252 for facilities cost of money it was not entitled to. Simplex should have billed for facilities cost of money based on direct labor costs incurred, as follows:

<u>Voucher No.</u>	<u>Amount billed by Simplex</u>	<u>Cumulative amount Simplex should have billed based on direct labor costs incurred</u>
1	\$ 78,496	<u>\$ 2,179</u>
4	146,250	<u>\$ 4,428</u>
22	<u>45,171</u>	<u>\$159,665</u>
Total	<u>\$269,917</u>	

As of voucher 22, Simplex had billed for \$269,917 whereas it properly should only have billed for \$159,665. Subsequently, on vouchers 29 and 31 Simplex adjusted the error by calculating the facilities cost of money properly and returned about \$100,000.

A Simplex official stated that the company billed for the facilities cost of money as it did because the company felt that the facilities cost of money costs were to be received as early in the contract life as possible in order to give contractors added incentive to invest in new plant and equipment. Simplex billed the Government in advance of contract performance on voucher 1 for the total estimated amount of facilities cost of money included in the original contract price; and, whenever the contract was modified, Simplex billed the Government for the modified estimated amount of facilities cost of money.

We pointed out that contract negotiations for this item clearly established a rate, based on direct labor costs incurred, as the method to recover the facilities cost of money earned by Simplex.

This matter was brought to the attention of responsible DCAA officials. We believe that in approving the vouchers for payment DCAA should have detected the error when comparing the amount of facilities cost of money billed to the direct labor costs reported by Simplex.

We did not compute the impact of interest costs to the Government for the payment of these funds to Simplex.

Improper allocation of general and administrative (G&A) costs resulted in overpayment by the Government

The contractor improperly allocated G&A costs to its facilities cost of money resulting in overpayment by the Government of \$3131.

Nuclear Metals, Inc. (NMI)
Concord, Massachusetts

NMI was awarded cost plus incentive fee (CPIF) contract DAAK10-79-C-0279 on September 24, 1979 for \$631,214 (as modified) by the U.S. Army Armament R&D Command, Dover, New Jersey, for fabrication and shipment of core penetrators.

NMI improperly allocated general and administrative (G&A) costs of ten percent on \$31,315 billed as facilities cost of money under the contract. Consequently, NMI was paid \$3,131 more than it was entitled to under the contract.

Facilities cost of money is a below the line cost, not subject to G&A allocation. During negotiations of a modification to the contract, NMI acknowledged this. Following the negotiations, however, NMI continued to allocate G&A on facilities cost of money billed on the vouchers submitted under the contract. We brought this matter to the attention of an NMI official who agreed that the G&A should not have been allocated against the facilities cost of money billed.

We informed the ACO and the responsible DCAA auditor of this matter; they advised NMI to return the funds to the Government. On November 24, 1981 the ACO told us that NMI had returned the funds. We feel that in approving the vouchers for payment DCAA would have detected this practice if it compared the applicable costs involved at ten percent to the amount of G&A actually billed.

Improper billing of cost before incurred
resulted in early payment by the Government

A small business contractor billed the Government for costs of \$10,171 before they were incurred.

Carbon Fiber Industries of New Hampshire, Inc., (CFI)
Lowell, Massachusetts

CFI was awarded CPFF contract N00123-80-C-0134 on December 31, 1979 for \$290,120 (as modified) by the Naval Regional Contracting Office, Long Beach, California to design, fabricate, test, and deliver a laundry system.

As a small business concern, CFI was allowed to bill the Government for costs that were incurred but not yet paid. However, CFI billed the Government for \$10,171 on voucher 5, dated August 1, 1980 in anticipation of the invoice which was received three weeks after the voucher was submitted to the Government. CFI paid the vendor after receiving the invoice.

Improper billing of precontract costs
resulted in overpayment by the Government

The contractor improperly billed for precontract costs resulting in overpayment of \$15,567 by the Government.

Nuclear Metals, Inc. (NMI)

NMI billed the Government and was paid \$15,567 under CPFF contract DAAK10-79-C-0279 for an engineering work study that did not qualify as a precontract cost.

Our review showed that NMI's original proposal for the contract was dated June 15, 1979 and that, by letter, dated July 25, 1979, the Contracting Officer allowed for precontract costs of \$80,000 subject to the express limitation that precontract costs would be allowed from the date a responsible NMI official--authorized to execute the contract--signed and returned a copy of the letter to the Contracting Officer until the date the contract was executed by both parties. The responsible NMI official signed the letter on July 27, 1979 and returned it to the Contracting Officer. The contract was executed on September 24, 1979.

Subsequently, NMI billed engineering work study costs of \$15,567 as material costs in its voucher for October 1979. Our review showed that NMI entered into the study more than two months prior to the date, July 27, 1979, established by the Contracting Officer to commence incurring precontract

costs. Specifically, NMI issued a purchase order on May 9, 1979 for services to vacuum heat treat and quench depleted uranium blanks in the two-chamber vacuum furnace. An NMI official informed us that the purchase order was issued so that NMI could obtain information on heat treating core penetrators that would be produced under this contract. The vendor submitted its invoice to NMI for this study on September 21, 1979. NMI initially recorded the cost as an overhead charge, but later issued a journal entry, dated November 5, 1979, transferring these costs to this contract as inventory work in process and billing them to the Government in its voucher for October 1979.

Based on the above, we consider these costs not to qualify as precontract costs; moreover, we noted that even if these costs did qualify and had been properly recorded by NMI, most of the cost still would not have been allowed since, (1) NMI claimed costs of \$78,010 through September 30, 1979 under voucher 1, and, (2) had the \$15,567 been added to these costs, they would have totaled \$93,577 and would have exceeded the \$80,000 limitation by \$13,577.

We discussed this matter with NMI's Vice-President for Finance who felt that the Government should pay for the study because it benefited from the information. We stated that in accordance with the terms of negotiations, these costs did not qualify as precontract costs. We informed the ACO and the responsible DCAA auditor of this matter; they advised NMI to return the funds to the Government. On November 24, 1981 the ACO told us that NMI had returned the funds.

Considering the nature of this issue, we believe that a cost audit by DCAA would have been necessary to detect the manner in which the contractor handled these costs.

Improper classification and billing of subcontract labor as direct material distorts composition of cost elements

The contractor misclassified and billed subcontract labor as direct material, thus obscuring the cost elements under total contract cost. However, we found no indication of improper loading of indirect costs.

Spears Associates, Inc. (Spears)
Norwood, Massachusetts

Spears Associates, Inc. was awarded CPIF contract N00024-79-C-7075 on June 5, 1979 for \$1,360,076 (as modified) by the Naval Sea Systems Command, Washington, D.C. to provide various towed buoy test sets.

Our review of direct material charges billed to the Government included costs incurred for subcontract labor. We examined about \$36,000 of direct material costs submitted for reimbursement and found about \$6,500 was attributable to subcontract labor.

Discussions with a Spears official disclosed that the company had issued five purchase orders, between September 1980 and January 1981 amounting to about \$13,000, for subcontract labor. The official stated that Spears did not anticipate the need for subcontract labor at the time of contract award. Thus, no provision was made in the contract. Spears did obtain the required approval from the ACO to place the purchase orders. The official stated that the Spears accounting system did not provide a means to record these costs under a separate cost category, and that these costs were charged to direct material as a means of recovering them from the Government. The official indicated that he would review the Spears accounting system to determine whether it could be expended to segregate these costs.

We reviewed the vouchers to determine whether improper loading of indirect cost had occurred but found no indication that such was the case. Although we are not aware of the legal ramifications of this practice, we feel that the composition of total contract costs is obscured and any Government analysis of material and labor costs under this contract for follow-on effort would be distorted.