



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

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NATIONAL SECURITY AND  
INTERNATIONAL AFFAIRS DIVISION

General Donald R. Keith  
Commander, U.S. Army Material Development  
and Readiness Command  
5001 Eisenhower Avenue  
Alexandria, Virginia 22333



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Dear General Keith:

Subject: More Effective Use of Audit Reports Needed to  
Reduce Contract Costs (GAO/NSIAD-83-54)

We have completed a review of M1 Tank Program Office contract administration practices under contracts DAAK30-77-C-0006 and DAAK30-77-C-0007 awarded to Chrysler Defense, Incorporated. Contract DAAK30-77-C-0006, awarded in 1976, initially provided for the first and second years' procurement of M1 production tanks on a fixed-price incentive basis. Contract DAAK30-77-C-0007, awarded in 1977, is a manufacturing, engineering, tooling, special test equipment, and facilities cost-plus-fixed fee contract to prepare for the production of the M1 tank. Both contracts ran concurrently.

Our overall objective was to determine the appropriateness of the M1 contracting officer's actions on Defense Contract Audit Agency (DCAA) reports on progress payment overcharges to contractors and misallocated contractor costs on M1 contracts. Additional objectives included determining whether the M1 contracting officer (1) followed sound and reasonable contract administration practices and (2) acted appropriately on DCAA audit reports to mitigate the cost impact of any contractor progress payment overcharges and contractor misallocated contract costs.

We made our review at the M1 Tank Program Office and at the U.S. Army Tank Automotive Command (TACOM), both in Warren, Michigan. We examined contract files, audit reports, and working paper files. In addition, we held discussions with contracting officials and resident auditors at the Lima Army Tank Center in Lima, Ohio, and at the Detroit Army Tank Plant in Warren, Michigan. This review was performed in accordance with generally accepted government auditing standards.

Details of our review are included in enclosure I. In summary, we found that the M1 contracting officer did not take prompt and effective action on 23 DCAA audit reports issued from

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February 1980 through August 1982. These reports questioned the allocation of about \$32 million of contractor costs incurred and the excess progress payments of about \$12 million made to the contractor. Most of the costs involve charges made to the cost reimbursement contract (C-0007), which the auditor believed should have been charged to the fixed-price incentive contract (C-0006). These charges would represent significant overpayments to the contractor because the maximum payments that could be received under the FPI contract are limited and, therefore, any cost incurred above this limitation must be absorbed by the contractor. We believe that the contracting officer should have acted expediently on DCAA's audit findings and taken strong and decisive action that would have prompted the contractor to resolve the findings as quickly as possible. Such action may have avoided possible contractor overpayments and lessened the amount of interest costs the Government would incur on any overpayments.

Department of Defense (DOD) Directive 5000.42 issued August 31, 1981 (superceded by DOD Directive 7640.2, December 29, 1982), sets forth guidance for the disposition of DCAA reports. Prompted by the requirements of this directive, the contracting officer began to inventory all audit reports not acted upon and established a schedule to resolve the audit findings problem with the contractor. The first report submitted under this directive was in October 1982. While this action should help to resolve the audit findings, we believe the contractor should be notified as soon as possible that the Government will assess interest on funds the contractor improperly has in its possession. We also believe that it is necessary to closely monitor the contracting officer's actions in responding to DOD Directive 7640.2.

The contract administration problems identified in this report and the contract pricing problems identified in our report to the Secretary of Defense (GAO/PLRD-83-21, Jan. 18, 1983) may in part be attributable to the unique contracting arrangement established for the M1 tank system. Unlike similar Army programs such as the Bradley Fighting Vehicle, the M1 program office was allowed to perform its own contracting rather than have TACOM which is normally responsible for procuring tank-automotive vehicles, perform this function. Also, TACOM is organized and staffed to handle all types of procurements, including large and complex ones such as the M1; whereas, the M1 program office had a small staff relative to the size and complexity of the M1 procurement and did not have the benefit of higher level procurement decision reviews required in TACOM. Furthermore, the M1 program office was subjected to pressures to meet tight milestone schedules for the development, initial production, and fielding of the M1 tank.

The reasons for deviating from the normal practice of having TACOM handle the contracting tasks for the M1 program were never formally documented or approved. We, therefore, believe that when

it is considered desirable to allow weapons system managers to handle their own contracting, the reasons for not assigning the contracting responsibility to the procurement commands should be documented.

We recommend that you

- closely monitor the M1 contracting officer's actions to ensure that the policies and procedures prescribed in DOD Directive 7640.2 are followed, the findings in DCAA's reports are resolved as expeditiously as possible, and contractor overcharges resulting from accounting deficiencies cited in DCAA's reports are identified and recovered;
- instruct the M1 contracting officer to notify the contractor that interest penalties will be imposed on contract overcharges and interest assessed pursuant to the Defense Acquisition Regulation; and
- insure that the decision to deviate from normal practice in having a procurement command handle the contracting tasks associated with weapon systems purchases is adequately documented, reviewed, and approved.

Although M1 program officials did not offer any written or formal comments on the draft report provided to them, they did make informal comments that were considered in preparing this report.

We are sending copies of this report to the Chicago Regional Director, DCAA; the Commanding General, TACOM; and the Vice President, Contracts and Estimating, General Dynamics, Land Systems Division.

Sincerely yours,



Robert M. Gilroy  
Senior Associate Director

Enclosures

MORE EFFECTIVE USE OF AUDIT REPORTS  
NEEDED TO REDUCE M1 COSTS

INTRODUCTION

The M1 tank program office, located in Warren, Michigan initially was responsible for the centralized management, development production, field, and follow-on support of the M1 Abrams tank system. The M1 program manager reported directly to the Commanding General of the U.S. Army Material Development and Readiness Command. From 1971 to 1981, the M1 program office awarded 40 contracts worth approximately \$2 billion for development, initial production, and related work on the M1 tank system. However, responsibility for the M1 program was transferred to TACOM in June 1983. The matters discussed in this report pertain to the contracts awarded and administered by the M1 program office.

During the period February 1980 to August 1982, DCAA issued 23 audit reports on overcharges and misallocation of costs totaling \$45 million under M1 contracts DAAK30-77-C-0006 and DAAK30-77-C-0007. These two contracts, with a combined value of about \$1.1 billion, constituted the largest portion of the contracted effort during the period.

Contract C-0006 was awarded to Chrysler Defense Incorporated, on November 12, 1976, and provided for full-scale engineering development of M1 tanks and options to acquire the first 2 years' production of tanks on a fixed-price incentive basis. Contract C-0007 a cost-plus-fixed fee, manufacturing startup contract, was awarded to Chrysler Defense on April 29, 1977, to prepare the Lima and Detroit tank plants for the production of M1 tanks. On March 16, 1982, Chrysler Defense was acquired by the General Dynamics Corporation and renamed Land Systems Division.

The manufacturing startup contract was to cover the cost of the entire manufacturing engineering effort and procurement of tooling, special test equipment, and facilities. Normally, a manufacturing startup contract is substantially complete before actual production begins. However, to keep the M1 program on schedule, the manufacturing startup and production contracts ran concurrently.

MORE EFFECTIVE USE OF DCAA AUDIT REPORTS  
NEEDED TO IMPROVE M1 CONTRACT ADMINISTRATION  
AND REDUCE M1 COSTS

The contracting officer did not take prompt and effective action on the findings included in 23 audit reports DCAA issued over a 2-1/2-year period on M1 contracts. These findings relate to contractor overcharges and accounting system deficiencies. As a result, the Government has no assurance that the contractor's accounting system can be relied upon for making accurate progress

payments and accepting costs. Moreover, the failure to take timely and effective action on 19 reports, involving over \$32 million of misallocations of contract costs could result in the contractor retaining and using about \$7.8 million in overpayments, interest free.

Of the 23 DCAA reports, four pertained to overpayments of about \$12.6 million for progress payments made under contract C-0006 and the other 19 involved misallocations of about \$32 million incurred under contracts C-0007 and C-0006. Most of the misallocations involved charges to contract C-0007, which should have been charged to contract C-0006.

The concurrent performance of the two contracts apparently created a situation that led to allocating costs between the two contracts improperly.

MORE TIMELY AND EFFECTIVE ACTION NEEDED  
TO CORRECT ACCOUNTING SYSTEM DEFICIENCIES  
DISCLOSED BY PROGRESS PAYMENT AUDITS

From February through July 1980, DCAA audited four progress payment vouchers at the request of the contracting officer and issued audit reports questioning approximately \$12.6 million in progress payment overcharges. These reports covered billing periods from October 1979 through March 1980. DCAA stated that most of the overcharges were attributable to contractor errors. For example, DCAA determined that due to procedural errors in summarizing costs for progress payment purposes and the lack of sound internal controls, the contractor erroneously included \$2.5 million of material costs. In another example, DCAA determined that the contractor duplicated a \$4.1 million billing in major subcontractor costs.

The contracting officer did not notify the contractor of the overpayments nor did he follow up on the findings to determine if appropriate corrections had been made. DCAA auditors, however, were able to obtain agreement from the contractor on these reports. Although appropriate accounting adjustments were made to satisfy DCAA, in several instances the contractor retained the overpayments for several months and was able to use this money with no charge by the Government for interest. For example, in one of the cited overpayments, there was a 6-month delay before the records were adjusted. As a result, the contractor realized an interest benefit of about \$156,000 based on the then current rates of interest.

Although the contractor had a history of erroneous progress payment billings, the contracting officer did not ask for additional progress payment audits on contract C-0006 after April 1980. The DAR states that a contracting officer is responsible for approving progress payment requests and requesting audits of contractors' progress payment billings. It further states that post review or post audits will be made when requested by the

contracting officer. Since four successive DCAA audits showed there were significant progress payment overcharges, we believe the contracting officer should have continued surveillance until erroneous charges were stopped.

The contracting officer informed us that he did not request additional specific audits because he assumed DCAA was performing the audits on a regular basis as he had asked DCAA to audit all progress payment requests. However, DCAA auditors stated that after receiving the contracting officer's request, they telephoned the contracting officer that it would be physically impossible to audit every progress payment voucher and that, in accordance with the DAR, future progress payment audits would be performed only when the contracting officer requested.

We requested DCAA to perform a test of progress payment billings on the first year's production contract to determine whether subsequent erroneous progress payment billings had occurred. DCAA found six instances of incorrect billings for the period from May 1980 to June 1981. These incorrect billings involved both overcharges and undercharges resulting in a net underbilling. In our view, the most significant conclusion to be drawn from this test is that the contractor continued to have problems with the accuracy of costs after DCAA had performed its last audit. DCAA stated that the numerous errors cited are indicative of a progress payment system that lacks proper internal controls to assure proper identification of billing costs for progress payments.

Further, results of a more recent DCAA audit suggests that deficiencies still exist in the system. Therefore, we believe that if the contracting officer had acted effectively on prior DCAA findings, the more recent disclosures may have been lessened. In September 1982 DCAA audited the first M1 tank production contract awarded by TACOM and questioned \$16.3 million in costs. In this instance, even prior to receipt of the audit report, the TACOM contracting officer notified the contractor that 25 percent of subsequent progress payment billings would be withheld until the contractor made appropriate changes to its system. We believe that had the M1 contracting officer taken similar strong and decisive action on prior DCAA findings, the contractor may have been prompted to initiate system corrections earlier.

MORE TIMELY AND EFFECTIVE ACTION NEEDED  
TO CORRECT MISALLOCATED CONTRACT COSTS  
AND RECOVER OVERPAYMENTS DISCLOSED BY AUDITS

The contracting officer also did not take prompt and effective action on DCAA reports regarding misallocated contract costs. As a result, audit reports questioning the misallocation of \$32.4 million in costs remains unresolved, and the contractor may have been overpaid an estimated \$7.8 million.

The contracting officer's failure to take timely action on the DCAA reports is illustrated by the following excerpts from a July 8, 1981, letter sent by DCAA to the contracting officer.

"During the last seven months we have issued seven \* \* \* audit reports that identified approximately \$7,700,000 of improperly charged costs to Government contracts."

\* \* \* \* \*

"Discussions with the contractor show that in only one case has your office requested \* \* \* to address the problems identified in an audit report."

\* \* \* \* \*

"In several instances we have been successful in getting the contractor to make significant cost adjustments strictly through audit actions."

\* \* \* \* \*

"\* \* \* We believe that \* \* \* to protect the Government's interest, contract management and audit must work closely together to resolve significant problems with the contractors systems and cost charging practices. I am willing to meet with you on any of these reports or provide you with copies of these reports if needed."

DCAA auditors informed us they never received a response to this letter and failed in several attempts to have the contracting officer meet with them on this matter. Nevertheless, the auditors worked informally with the contractor to obtain adjustments. In their opinion, these informal negotiations resulted in obtaining agreement with the contractor on the audit questions cited in a few of the reports. These reports, as well as the others, are still considered to be unresolved because the contracting officer has failed to involve himself in their resolution.

Contracting officers rather than auditors are responsible for conducting negotiations with contractors. While the contractor's representatives were apparently willing to informally resolve a few of the findings to the satisfaction of the auditors, this informal process cannot be relied upon to adequately protect the Government's interest. Moreover, according to DCAA auditors, General Dynamics is taking a more formal approach to the findings than Chrysler management and such informal resolutions as were effected in the past are less likely in the future. Therefore, we believe that it is imperative for the contracting officer to fulfill his assigned responsibilities.

Subsequent to the seven reports cited above, DCAA continued to issue other reports on misallocated contract costs and, as of December 31, 1982, DCAA had issued 19 reports questioning the allocation of \$32.4 million. Our analysis of the 19 reports disclosed that \$25.2 million was improperly charged to cost-plus-fixed fee contract C-0007 and \$7.2 million was improperly charged to other contracts. Also, most of the \$25.2 million, or \$15.6 million, should have been charged to fixed-price incentive fee contract C-0006 with the remainder to other Government contracts.

Contract C-0007 allows recovery of all allowable costs incurred; whereas, contract C-0006 contains ceiling provisions that limit the amount the Government will pay. As shown in the following schedule, if the \$15.6 million was properly chargeable to C-0006, the contractor would have been entitled to only \$7.8 million paid under C-0007.

Estimated Recoverable Overpayments  
Based on DCAA Reported Cost Misallocations  
Between Contracts C-0007 and C-0006

	(millions)
Contract C-0006 price ceiling	\$198.0
Charges as of 6/30/82	<u>190.2</u>
Amount of cost contract C-0006 can still absorb	<u>\$ 7.8</u>
Estimated overpayment to C-0007 and corresponding underpayment to C-0006 (note a)	\$ 15.6
Amount of cost contract C-0006 can absorb	<u>7.8</u>
Estimated overpayment for costs incurred which exceeded the ceiling price and must be absorbed by the contractor	<u>\$ 7.8</u>

a/ Enclosure II shows the DCAA reports and estimated cost misallocations used to compute this amount. The DCAA reports only estimate the amount of the cost misallocations. Once the contractor submits cost impact statements and the reports are settled, the misallocated amounts and overpayments will likely be different.



IMPLEMENTATION OF DOD DIRECTIVE 7640.2  
MAY IMPROVE ACCOUNTABILITY AND TIMELY  
DISPOSITION OF DCAA AUDIT REPORTS

The contracting officer has taken some action on DCAA reports by soliciting the contractor's responses on the reports that have not been resolved. This action apparently stems from the DOD Directive 5000.42, issued August 31, 1981 (superceded by DOD Directive 7640.2, December 29, 1982), which sets forth guidance for the disposition of DCAA reports.

DOD Directive 7640.2 prescribes followup policies for management action on DCAA contract audit recommendations. The directive establishes a DOD followup system that:

- Provides for tracking and reporting on most significant DCAA contract audit reports, including audits of incurred costs and Cost Accounting Standards compliance. This includes submitting status reports to the Assistant Secretary of Defense on all tracked audit recommendations that remain open 6 months after the date of the audit reports. The first status report was due March 31, 1982.
- Sets forth a mechanism for contracting officers and auditors to resolve differences concerning settlement of significant contract audit recommendations. Each DOD component is required to designate an independent senior acquisition official to review and rule on differences between contracting officers and auditors.
- Provides for early resolution of differences and continuous communication between auditors and contracting officers. Differences of opinion on significant recommendations shall be promptly brought to the attention of designated officials or review boards.
- Requires the contracting officer to prepare memorandums covering the disposition of all audit report recommendations and underlying rationale for such disposition. A copy is to be provided to the contract auditor and the independent senior acquisition official or board.

The M1 contracting officer has taken initial steps to comply with DOD Directive 7640.2. The office has established a system to identify and track unresolved audit reports. Also, although it did not meet the March 31, 1982, target date, it did submit its first semiannual status report in October 1982.

The followup actions on DCAA audit reports prompted by the implementation of DOD Directive 7640.2 apparently created a backlog problem for the contractor. On August 30, 1982, the contractor proposed a milestone schedule for responding to the DCAA audit reports. In submitting the schedule, the contractor is

claiming it has a large backlog of DCAA reports on both the M60 and M1 contracts. According to the contracting officer, the contractor believes that the reports deal with an accounting system inherited from Chrysler Defense Corporation and additional time was needed to respond to each report. Although there have been some disagreements concerning which reports should be on the schedule, the Army contracting officers' responsible for these contracts have basically agreed with the contractor's proposed schedule. According to this schedule, the contractor is committed to respond to the 19 unresolved reports during the period September 30, 1982, through May 23, 1983. These responses represent the first step in the resolution process.

In taking this first step, however, the contracting officer did not take action that would provide an incentive for the contractor to expedite resolution of the auditing finding. For example, he did not notify the contractor of possible interest penalties or otherwise indicate that consideration had been given to the use of DAR interest penalties.

ASSIGNING CONTRACTING RESPONSIBILITIES  
TO THE M1 PROGRAM OFFICE MAY HAVE CONTRIBUTED  
TO POOR CONTRACT ADMINISTRATION PRACTICES

We believe the apparent low priority given to contract administration can, in part, be attributed to the unique arrangement whereby the M1 program office was allowed to perform its own contracting. Also, in our view, the M1 program office's procurement staff was small relative to the complex contracting responsibilities for acquiring a large and complex weapon system such as the M1 tank. This combined with pressures to meet tight milestone schedules for the development, initial production, and fielding of the M1 contributed to the indicated low priority given to contract administration duties discussed in this report.

Informal delegation of contracting authority

The M1 project manager's charter does not include provisions for the M1 program office to perform its own contracting and there is no formal document to this effect. The authority was apparently informally granted by the U.S. Army Material Development and Readiness Command through its approval of procurement personnel slots for the M1 program office. The contracting officer believed that the office was given this authority and not TACOM in the early stages of tank production because it would provide more continuity, more flexibility, quicker response time, and more dedicated people.

Procurement workload

In handling the contracting responsibilities during the early phases of production, the M1 program office took on a difficult and complex task. From 1976 to 1980, the M1 procurement staff,

which averaged about 10 people, awarded contracts worth about \$1.7 billion; whereas, TACOM has assigned 17 people to make procurements for the similar Bradley Fighting Vehicle System. Moreover, TACOM is able to use the resources of its procurement directorate, consisting of several hundred people on a part-time basis whenever necessary.

Contracts C-0006 and C-0007 were also particularly complex and difficult to administer. The concurrent running of these contracts made things even more difficult. Contract C-0006 not only covered the first 2 years of tank production, but also included line items for spares and training components. The definition of work for contract C-0007 proved particularly troublesome, especially in differentiating between functions and charges pertaining to the tank production and other M1 contracts.

The M1 program office also experienced contracting inadequacies other than those addressed in this report. In our January 18, 1983, report, we pointed out that the M1 contracting officer did not obtain fair and reasonable prices for M1 spare because he (1) accepted excessive ceiling prices for spares negotiated on a sole-source basis without obtaining cost or pricing data, (2) combined the sole-source spare ceiling price with one competitively established in the original contract and (3) permitted inappropriate transfers of spares between contracts. The last two actions unnecessarily allowed the contractor to recoup \$5.6 million in costs that it would not otherwise be entitled to.

The Army's normal practice of separating procurement from the major weapon system office provides a natural check and balance, whereby the procurement goals of obtaining fair and reasonable contract costs and prices are separated from other goals and objectives. Under the Army's normal procurement arrangement a procurement command handles the contracting and gives a high priority to obtaining fair and reasonable contract costs and prices. In contrast, a major weapons system program office has other objectives, such as keeping the program on schedule or achieving test objectives, that may conflict with these goals. Thus, we believe the Army's decision to provide the M1 program office its own contracting authority may have contributed to the poor contracting practices described in the prior report and the contract administration problems discussed in the report.

SUMMARY OF DCAA REPORTSON COST MISALLOCATIONS

<u>DCAA report No.</u>	<u>Date of report</u>	<u>Questioned costs contract C-0007</u>	<u>Potential overcharges to C-0007 undercharges to C-0006</u>
3281-2C444.023	07-22-82	\$ 452,560	\$ 452,560
3281-2C444.010	04-28-82	4,450,000	4,450,000
3281-9D130.010	05-05-80	98,000	98,000
3261-1-130001	03-27-81	1,707,000	1,707,000
3261-2-130012	08-03-82	8,413,817	8,413,817
3261-2-130007	05-19-82	3,356,133	1,510,410
3261-1-120103	09-10-81	2,970,000	2,970,000
3261-1-444008	06-30-81	335,000	148,565
3261-2-444003	02-11-82	843,076	525,392
3261-0C130004	12-10-80	233,000	233,000
3261-2C-444020	07-28-82	1,733,780	
3281-2C-444018	06-18-82	266,964	
3281-2C-444019	06-24-82	183,967	
3281-2C-444008	06-18-82	101,452	
3261-2-140001	12-03-81	115,000	
Total		<u>\$25,259,749</u>	

\$20,508,744

Portion of questioned costs properly chargeable to C-0006

Other contracts

3281-2C444.016	05-12-82	\$ 670,000
3261-1-120101	04-16-81	4,314,000
3261-1-110102	04-22-81	442,000
3261-2-110006	05-19-82	1,727,844
Total questioned costs		<u>\$32,413,593</u>

Less reports for which DCAA obtained agreement with the contractor

3261-1-130001	\$ 1,707,000
3261-1-120103	2,970,000
3261-0C130004	233,000
3261-1-120101	
3261-1-110102	
Total	<u>\$ 4,910,000</u>

Net portion of questioned costs properly chargeable to C-0006

\$15,598,744