



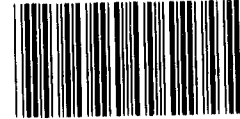
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

~~30124~~
125941

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

DECEMBER 13, 1984

B-208826



125941

The Honorable Caspar W. Weinberger
The Secretary of Defense

Dear Mr. Secretary:

Subject: Accurate and Complete Subcontract Data Needed
To Assess International Agreements on Defense
Procurement (GAO/NSIAD-85-30)

We are reporting to you on improvements needed in the Defense Department's subcontract-level reporting system.¹ This report is an outgrowth of work we did in response to a June 1984 request from the Chairman of the Subcommittee on Defense, Senate Committee on Appropriations. We made available for his use briefing papers on (1) Defense's collection of information on its foreign-source procurements at the prime and subcontract levels, (2) the buy-national provisions affecting Defense procurement and waivers to those provisions, and (3) the current state of knowledge regarding the costs and benefits of these buy-national provisions. We also made these papers available to members of the International Acquisitions staff of the Office of the Under Secretary of Defense for Research and Engineering.

We believe that improvements are needed in both the design and operation of the subcontract reporting system. The International Acquisitions staff needs personnel resources to properly operate the system. Moreover, Defense could improve the system's operation by (1) establishing a method for assessing compliance,

¹We previously issued two reports on Defense efforts to collect subcontract data. Our May 5, 1982 report, Agreements On Inter-NATO Defense Trade (ID-82-30), concluded that Defense efforts to collect this information would be appropriate and concurred with the agency's request for funding to establish and maintain the system. Our January 21, 1983 report, Defense Department Subcontract-Level Reporting System (GAO/ID-83-30), reported that the system was not yet operational and expressed reservations about its design.

(483403)

030 916

(2) revising the method used to designate foreign-source procurements, (3) requiring contractors to report on foreign-source procurements of commercial items and (4) requiring contractors to use the predesignated form to submit information.

BACKGROUND

Defense has entered into general Memorandums of Understanding (MOUs) with 13 North Atlantic Treaty Organization (NATO) allies.² Through these MOUs, the countries agree to give equal consideration to products from other signatories in making defense-related procurements. The MOUs aim at promoting competitive defense trade by giving suppliers from each NATO country an equal opportunity to benefit from defense procurements. By expanding competition, the MOUs could potentially improve the interoperability of NATO defense systems and reduce pressures for special co-production and offset arrangements. To assess the success of these MOUs, the signatories meet annually and, among other things, review and reconcile information on procurement activity under the MOUs.

Defense collects information on its foreign-source procurements through two reporting systems. Under the prime contract reporting system (DAR 21), Defense procurement officers submit reports (form DD350) on procurement contracts (and contract modifications) valued at more than \$25,000. These reports contain information on, among other things, the contract value and source of the product or service purchased.

Under the subcontract-level reporting system (DAR 1-340 and 7-104.78), prime contractors awarded contracts (or contract modifications) for other than commercial items³ exceeding \$500,000 and first-tier subcontractors (i.e., those that sell directly to prime contractors) awarded contracts for other than commercial items exceeding \$100,000 are required to report on foreign-source purchases valued at more than \$10,000. (Procurements of ores, natural gas, utilities, petroleum products and crudes, timber, and subsistence items are excluded from this requirement.)

²Belgium, Canada, Denmark, France, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Turkey, the United Kingdom, and West Germany. Defense has also concluded general MOUs with Egypt and Israel.

³Federal procurement regulations (FAR 11.001) define a commercial product as "a product, such as an item, material, component, subsystem, or system, sold or traded to the general public in the course of normal business operations at prices based on established catalog or market prices."

A reporting system that collects accurate and complete information on foreign-source procurements at the subcontract level is important to Defense's efforts to encourage competitive defense trade through the bilateral MOUs. Having such information would help Defense to assess its participation in the MOUs and more fully demonstrate to other signatories the trade benefit they gain from participating in the MOUs. It would also enable Defense to be more responsive to congressional inquiries and proposals on buy-national restrictions applicable to defense procurements. In performing this work for the Chairman, we identified the following improvements needed in the design and operation of the subcontract-level reporting system.

RESOURCE, COMPLIANCE, AND DESIGN PROBLEMS
HINDER OPERATION OF SUBCONTRACT SYSTEM

According to International Acquisitions staff, additional personnel resources are needed to operate the subcontract-level reporting system properly. At present, one individual works on the system as a collateral duty. The staff believes that at least one full-time person is needed to properly establish the system. Resource requirements would likely decrease as the system became operational. Among other things, staffing constraints have limited efforts to computerize the compilation of information; thus, the staff continues to perform this function manually. According to International Acquisitions staff, the use of computers would reduce the time needed to compile the information and the potential for error.

Efforts to encourage compliance with the subcontract-level reporting system have not been fully successful. Defense procurement regulations require the Army, Navy, Air Force, and Defense Logistics Agency to include in procurement contracts a clause requiring contractors to comply with this system. In addition, Defense has asked the services to otherwise inform prime and subcontractors of this requirement. Yet, the International Acquisitions staff has found that contractors have not submitted required reports. As a result, less than full compliance may have lessened the validity of the data developed by the system.

We also noted several areas for improvement in the system's design. The International Acquisitions staff has not instituted a method for assessing compliance with the system. Defense officials, therefore, cannot always differentiate between contractors that failed to comply and those that did not submit reports because they had no contracts meeting the criteria. One way to assess compliance would be a negative reporting requirement (i.e., a requirement that contractors periodically report that they do not have contracts meeting the criteria).

The system's method for indicating whether a procurement is domestic or foreign-source can result in incomplete information. Defense procurement regulations require contractors to report on subcontracts where the "principal place of performance" was outside the United States. Using this method, contractors purchasing foreign-made goods from domestic suppliers do not have to report the purchase into the system. For instance, a contractor purchasing a foreign-made computer from a wholesale supplier in New York would not need to submit a report on the purchase since the principal place of performance was New York. In contrast, the prime contract reporting system employs "country of origin," which identifies the exporting country, to indicate whether a procurement is domestic or foreign-source. We believe that "country of origin" is a more reliable indicator of foreign-source procurements.

Our January 1983 report (see p. 1) noted that, because the subcontract-level reporting system excludes contracts for commercial items, the system collects no information on a significant and growing category of procurements. The MOUs cover most procurements of commercial items. Defense collects information on commercial procurements at the prime contract level and includes information on covered commercial purchases when reporting on its activity under the MOUs.⁴ The exclusion of such information at the subcontract level results in under-reporting of U.S. foreign-source procurements, thus overstating the U.S. trade surplus under the MOUs.

In addition, many firms are not using the form created for the subcontract reporting system (form DD2139) to report information but are simply relaying the information through letters. They can do this because Defense regulations do not require that the form be used. According to International Acquisitions staff, contractors submitting information in letters may not be reporting all the required information. Further, since form DD2139 contains the instructions for compiling and reporting subcontract information, the staff cannot be sure that contractors are using the correct definitions and methodologies. For instance, form DD2139 instructs contractors to report the "dollar amount of the subcontract commitment or modification thereto." A contractor unaware of this instruction could submit information on a different basis, such as expenditures on current subcontracts. Similarly, contractors may use differing definitions to determine whether a procurement is domestic or foreign-source.

⁴Defense excludes information on procurements of subsistence items, petroleum, construction, and support services from the information on its procurements under the MOUs.

DEFENSE ACTIONS TO IMPROVE
THE SUBCONTRACT REPORTING SYSTEM

Defense officials have taken some steps to improve the operation of the subcontract-level reporting system. They have reinstructed the Services to inform contractors of this requirement. They are also attempting to revise the Defense regulations to require that contractors use form DD2139 to submit information. This revision is pending approval of the Defense Acquisition Regulatory (DAR) Council, which promulgates changes to the Defense supplement to the Federal Acquisition Regulations. We believe this revision is needed and should be implemented as quickly as possible.

CONCLUSIONS

Because of deficiencies in the design and operation of the subcontract reporting system, Defense does not have information showing the full extent and details of its purchases from the other MOU signatories. Thus, the information it does have overstates the U.S. trade surplus under the MOUs, which could potentially raise concerns in the other signatory governments that the United States is receiving an inequitable share of the trade benefits under the MOUs.

RECOMMENDATIONS

We recommend that you make available the required personnel to maintain and operate the subcontract-level reporting system, consistent with Defense's overall staffing needs and priorities. We also recommend that you revise the Defense supplement to the Federal Acquisition Regulations and, when necessary, form DD2139, to:

- Institute a method for assessing compliance with the subcontract-level reporting system, such as a negative reporting requirement.
- Require that the subcontract-level reporting system use "country of origin" rather than "principle place of performance" to indicate foreign-source procurements.
- Require that contractors receiving contracts for commercial items report on subcontracts meeting the value threshold for reporting, except procurements of ores, natural gas, utilities, petroleum products and crudes, timber, and subsistence items.

AGENCY COMMENTS AND OUR EVALUATION

The Department of Defense commented on this report. (See enc. I.)

Defense concurs that, due to deficiencies in the subcontract-level reporting system, it does not have information showing the full extent of its purchases from other MOU signatories. Defense did not concur, however, that the information currently available results in either an overstatement of the U.S. trade surplus or that the alleged overstatement could potentially raise concerns by the other signatory governments. It stated that the NATO countries are aware that data collected is inexact and use negotiated final figures and ratios rather than those from any individual reporting system. Further, Defense noted that the trend over the years in these trade ratios is a much more significant item for discussion with our allies than exact figures reflecting purchases.

We understand that negotiations are presently used to arrive at the final figures and ratios of procurement activity under the MOUs and that the trend over the years has a significant impact on agreements reached. Nevertheless, more accurate and complete information on U.S. government foreign-source procurements at the subcontract level would place U.S. representatives in a stronger position to demonstrate the trade benefits accruing to the other signatories and better insure that U.S. foreign-source procurements at the subcontract level were fully considered by U.S. negotiators.

With regard to specific findings and recommendations, Defense stated that it plans to revise Defense procurement regulations to require use of form DD2139. Defense also agreed to use "country of origin" to indicate foreign-source procurements by the end of fiscal year 1985 and take action on our other recommendations, subject to the following comments.

Defense concurred with our finding that more resources could be used to operate the subcontract-level reporting system, but pointed out that overall resource allocation priorities must be considered in implementing our staffing recommendation. We agree and have worded the recommendation accordingly.

Defense concurred with our finding that it has no method for assessing compliance with the subcontract-level reporting system and, as a result, it cannot always differentiate between contractors that are failing to comply and those with no contracts meeting the criteria. However, Defense pointed out that a negative reporting requirement may not be the best alternative since it conflicts with government efforts to reduce paperwork. It intends to task the military services and Defense Logistics Agency

to undertake a study to identify the best method for assessing compliance and report on their findings by the end of fiscal year 1986. We agree that methods other than a negative reporting system could also be appropriate and have worded our recommendation accordingly.

Defense agrees that excluding commercial contracts from the subcontract-level reporting system could cause the system to understate U.S. government purchases from other MOU signatories. However, before implementing our recommendation, Defense would like greater assurance that this change could be easily implemented and that it would markedly increase the information on procurement activity under the MOUs. It intends to task the services and Defense Logistics Agency to assess the extent of this problem and to determine the difficulty of accounting for and reporting on commercial purchases under Defense contracts. We agree with Defense as to the need for such a study to assess the potential impact of implementing our recommendation.


Our review was made in accordance with generally accepted government audit standards.

- - - - -

As you know, 31 U.S.C. §720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Chairman of the Subcommittee on Defense, Senate Committee on Appropriations; other appropriate congressional committees; Director, Office of Management and Budget; and other interested parties.

Sincerely yours,


for Frank C. Conahan
Director



THE UNDER SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301 - 3010

RESEARCH AND
ENGINEERING

6 December 1984

(AM)

Mr. Frank C. Conahan
Director, National Security and
International Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to your letter of October 10, 1984, which transmitted your Draft Report (GAO Code No. 483403) entitled, "Accurate and Complete Subcontract Data Needed to Assess International Agreements on Defense Procurement" (OSD Code No. 6623).

The primary objective of the Subcontract Reporting System is to compile subcontracts awarded to foreign sources with a reciprocal procurement Memorandum of Understanding. The subcontract data, together with the data on contracts awarded directly by the DoD, reflect the total DoD purchases.

The GAO report highlights areas where the subcontract data in the DoD reporting system could be more comprehensive so as not to understate the DoD purchases from foreign sources. Before addressing either the findings or the recommendations, it is important to place in proper perspective the various reporting systems. The DoD system, at both the prime and subcontract levels, is a mandatory system. In contrast, most of the NATO country systems are voluntary. Both the U.S. and the NATO countries understand and are aware of the deficiencies in the systems, and use negotiated final figures and ratios, rather than those from any individual reporting system. Accordingly, while the DoD generally concurs with the findings in the GAO draft report, the conclusions require further study.

Detailed DoD comments addressing each of the findings and recommendations contained in the draft report are in the enclosure to this letter. These comments will answer the GAO questions regarding the subcontract system. The opportunity to comment on the report in draft form is appreciated.

Sincerely,

A handwritten signature in cursive script that reads "Robert S. Cooper".

Robert S. Cooper
Acting

Enclosure

GAO DRAFT REPORT DATED OCTOBER 10, 1984
(GAO CODE NO. 483403) OSD CASE NO. 6623

"ACCURATE AND COMPLETE SUBCONTRACT DATA NEEDED TO ASSESS
INTERNATIONAL AGREEMENTS ON DEFENSE PROCUREMENT"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

- o **FINDING A: Deficiencies In The Department Of Defense's Subcontract Reporting System Could Result In Understatement Of U.S. Defense Purchases From NATO Allies.** The GAO noted that the Department of Defense (DoD) Memoranda Of Understanding (MOU) with 12 North Atlantic Treaty Organization (NATO) allies are intended to give suppliers from each NATO country an equal opportunity to benefit from NATO defense procurements, and improve interoperability of defense systems. The GAO found that the DoD collects data on the foreign-source procurements under reporting systems for prime contracts and, separately, for subcontracts. The GAO concluded that, due to several deficiencies in the design and operation of the subcontract reporting system (detailed in subsequent findings) and not all contractors complying with the reporting system, the DoD does not have information showing the full extent and detail of its purchases from the other MOU signatories. The GAO also concluded that the information available overstates the U.S. trade surplus under the MOUs, which could potentially raise concerns in the other signatory governments about the U.S. receiving an inequitable share of the MOU benefits. (pp. 2-4, and 8, GAO Draft Report)

DoD RESPONSE: Partially concur. The DoD concurs that due to deficiencies in the subcontract reporting system it does not have information showing the full extent of purchases from other MOU signatories. The DoD does not concur, however, that the information currently available results in either an overstatement of the U.S. trade surplus or that the alleged overstatement could potentially raise concerns by the other signatory governments. The MOU signatories recognize that the data collected by Nations in this area is inexact. In fact, a number of the MOU signatories use systems relying on voluntary reporting by contractors. In recognition of this, the United States negotiates with the other MOU signatories. In these negotiations final figures are developed to reflect purchases on both sides and

agreement is reached on a resultant trade ratio. The trend over the years in these trade ratios is a much more significant item for discussion with our Allies than exact figures reflecting purchases.

- o **FINDING B: Staffing Constraints Hamper Defense's Operation Of The Subcontract Reporting System.** The GAO found that, at present, one person works on the subcontract reporting system as a collateral duty, whereas the DoD International Acquisitions staff acknowledges that at least one full-time staff person is needed. The GAO also found that, according to this staff, computers would reduce time and error in the compilation of the information, but due to staffing constraints, this has not been accomplished. (p. 4, GAO Draft Report)

DoD RESPONSE: Concur.

- o **FINDING C: Exclusion Of Commercial Items From Reporting On Subcontracts Results In Under-Reporting Of U.S. Foreign-Source Procurements.** The GAO found that under the subcontract reporting system, prime contractors awarded contracts (or contract modifications) on non-commercial items exceeding \$500,000, and first tier subcontractors (those selling directly to prime contractors) awarded contracts for non-commercial items exceeding \$100,000, are required to report on foreign-source purchases valued at \$10,000 or more, except procurement of ores, natural gas, utilities, petroleum products and crudes, timber, and subsistence items. The GAO noted that, in its previous report (OSD Case No. 6196), it found that because the subcontract level reporting system excludes contracts for commercial items, the system collects no information on a significant and growing category of procurements. The GAO also found that Defense collects, and reports to allies, information on commercial procurements at the prime contracting level but not at the subcontracting level. The GAO concluded that the exclusion of such subcontracting information results in under-reporting of U.S. foreign source procurements. (pp. 3-5, and 6, GAO Draft Report)

DoD RESPONSE: Partially concur: The extent of commercial purchases from foreign sources under DoD subcontracts is at issue here. It is possible that by the absence of a provision requiring commercial purchases to be reported, the subcontracting reporting system is failing to capture purchases from other MOU signatories which are applied to Defense contracts. If this information would cause a marked adjustment in agreed trade ratios then the subcontracting reporting system should be modified to

reflect such information. The DoD will task the military Services and the Defense Logistics Agency to check subcontracts to assess the extent of this problem and to determine the difficulty of accounting for and reporting on such purchases under DoD contracts. Some commercial items may not come under the scope of the MOUs and the NATO countries would object to these items being counted. This assessment will be completed at the end of FY 86.

- o **FINDING D: Without A Negative Reporting Requirement, Defense Cannot Assess The Extent To Which Contractors Are Not Complying With Subcontractor Reporting Requirements.** The GAO found that contractors not having contracts meeting the criteria do not have to submit reports. The GAO concluded that Defense officials cannot always differentiate between contractors that are failing to comply and those with no contracts meeting the criteria. (pp. 4-5, GAO Draft Report)

DoD RESPONSE: Partially Concur: The DoD concurs that it cannot always differentiate between contractors that are failing to comply and those with no contracts meeting the criteria. The DoD has not concluded, however, that a negative reporting system is the best alternative to insure compliance. (Also, see the response to Recommendation 2.)

- o **FINDING E: Method Used To Designate Foreign-Source Procurements Requires Revision.** The GAO found that the subcontract reporting system method for indicating whether a procurement is domestic or foreign-source can result in incomplete information. Specifically, the GAO found that subcontract reporting system regulations refer to "principal place of performance," rather than "country of origin" as stipulated for reporting on prime contracts. Since the former can be interpreted to mean "point of delivery," the GAO concluded that a subcontractor purchasing a foreign-made computer from a wholesale supplier in New York might interpret this as a domestic purchase. The GAO also concluded that "country of origin" is more reliable since it indicates the exporting country. (p. 5, GAO Draft Report)

DoD RESPONSE: Concur.

- o **FINDING F: Failure To Use DD Form 2139.** The GAO found that many firms are not using DD Form 2139 to report information because DoD regulations do not require its use. The GAO concluded that this may result in incomplete or inconsistent data. The GAO noted that Defense officials are revising regulations to require contractors to use this form, and this revision is pending approval of the Defense Acquisition Regulations Council. The GAO concluded that the revision is needed and should be implemented as quickly as possible. (pp. 6, 7, GAO Draft Report)

DoD RESPONSE: Concur.

RECOMMENDATIONS

- o RECOMMENDATION 1: The GAO recommended that the Secretary of Defense make available the required personnel to maintain and operate the subcontract level reporting system. (p. 8, GAO Draft Report)

DoD RESPONSE: Partially Concur. The DoD concurs that more resources could be used to work this problem, but manpower allocation will be based on overall resource utilization and priorities.

- o RECOMMENDATION 2: The GAO recommended that the Secretary of Defense revise the Defense supplement to the Federal Acquisition Regulations to require the subcontract reporting system to include a negative reporting requirement. (p. 8, GAO Draft Report)

DoD RESPONSE: Nonconcur. The DoD agrees that there is a problem that could be fixed by a negative reporting system, however, it questions if this is the best alternative. A negative reporting system could generate additional paperwork for no purpose. The DoD is concerned that a number of U.S. prime contractors do not subcontract with foreign firms and will have to submit additional reports. This would conflict with paperwork reduction efforts. The DoD prefers to study this problem further and determine the best alternative to insure compliance. A study to determine the extent of failure to report such data and to determine the best way to ensure compliance will be tasked to the Services and the DLA. This study will be completed by end FY 86.

- o RECOMMENDATION 3: The GAO recommended that the Secretary of Defense revise the subcontract level reporting system to require the use of "country of origin" rather than "principal place of performance" to indicate foreign-source procurements. (p. 8, GAO Draft Report)

DoD RESPONSE: Concur. This change will be made by end of FY 85.

- o RECOMMENDATION 4: The GAO recommended that the Secretary of Defense revise the Defense supplement to the Federal Acquisition Regulations to require contractors receiving contracts for commercial items to report on subcontracts meeting the value threshold for reporting, except procurements of ores, natural gas, utilities, petroleum products and crudes, timber, and subsistence items. (p. 8, GAO Draft Report)

DoD RESPONSE: Partially Concur. Defense is not sure there is a problem as defined. The DoD will examine this proposed problem further. If there is a problem, the DoD will take appropriate steps to ensure that such commercial purchases are reflected in trade ratios with our Allies.