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

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
THURSDAY, OCTOBER 3, 1985

STATEMENT OF
FRANK C. CONAHAN, DIRECTOR
NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION
BEFORE THE
SUBCOMMITTEE ON LEGISLATION AND NATIONAL SECURITY
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
GAO WORK AT DEFENSE CONTRACTOR PLANTS



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Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss the results of GAO's work to date at major defense contractor plants. The work is being performed at the request of this Subcommittee and the Senate Governmental Affairs Committee. Last year we determined that several aspects of Department of Defense (DOD) contracting activities should be evaluated. They relate to

--the reasonableness of subcontract costs negotiated in prime contract prices,

--DOD's surveillance of contractors' cost estimating methods and practices,

--DOD's use of unpriced contracts,

--adequacy of technical reviews of contractors' price proposals, and

--overhead costs.

We have not begun work on technical reviews and have just started evaluating DOD's use of unpriced contracts. My testimony today will cover subcontract pricing, surveillance of contractor estimating systems, and overhead settlements. Our work has been

performed at segments of ten major defense contractors selected from the 50 largest defense contracting firms. The locations we visited are listed in attachment I to this testimony.

Our review of subcontract pricing and DOD's surveillance of contractor cost estimating methods and practices focused on the safeguards DOD employs to protect against inflated contract prices. Our work on overhead cost settlements expands on the testimony I presented to this Subcommittee in July 1984 on public relations costs, and testimony we presented to other committees earlier this year.¹

SAFEGUARDS FOR PRICING
NONCOMPETITIVE CONTRACTS

DOD's goal is to award as many contracts as possible on a competitive basis. However, in fiscal year 1984, DOD awarded about \$82 billion in prime contracts without price competition. Because competitive marketplace forces are absent, DOD must rely, to a great extent, on cost estimates developed and submitted by contractors. The extent to which such cost estimates exceed a

¹Statement of Frank C. Conahan, Director, National Security and International Affairs Division, before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, April 23, 1985.

Statement of Paul F. Math, Associate Director, National Security and International Affairs Division, before the Subcommittee on Investigations of the House Committee on Armed Services, May 20, 1985.

reasonable approximation of the ultimate cost of contract performance may give rise to unjustified gains or enrichments at the expense of the government.

Recognizing the government's vulnerability in negotiating noncompetitive contract prices, the Congress passed the Truth-in-Negotiations Act, Public Law 87-653, 10 U.S.C. 2306(f), in 1962. The Act is intended to protect the government against inflated cost estimates and eliminate overpriced contracts. The Act requires contractors to submit cost or pricing data to support certain noncompetitive price proposals, and to certify at the time of prime contract price agreement that the data submitted are accurate, complete, and current. It also provides for price reductions if it is later found that any defective data in proposals have significantly increased contract prices.

In addition, procurement regulations contain a number of controls that are designed to protect the government's interests and provide assurances that subcontract cost estimates included in prime contract prices are fair and reasonable. DOD also requires the Defense Contract Audit Agency (DCAA) to maintain a regular program for reviewing contractors' cost estimating practices in order to increase the reliability of contract proposals.

Our work identified a number of significant deficiencies that raise concern about whether DOD contracting officers are negotiating fair and reasonable contract prices. While the deficiencies we found can not be projected to represent all DOD contracting actions, we believe they are, in themselves, significant, and deserve serious consideration.

We believe improvements are needed, particularly regarding subcontract pricing and surveillance of contractor cost estimating methods and practices, in order for DOD to have greater assurance that contract prices are fair and reasonable.

I will now discuss each of the areas covered in our reviews.

SUBCONTRACT PRICING SAFEGUARDS WERE
NOT EFFECTIVELY IMPLEMENTED

Subcontract costs are significant elements to be considered during negotiation of prime contracts--comprising from 40 to 60 percent of prime contract values. Our review included 26 prime contracts totalling about \$10.8 billion. We examined 268 subcontract cost estimates amounting to about \$1.5 billion. Of these 268 cost estimates, 168 were priced before prime contract negotiations and 100 were priced after prime negotiations. These latter cost estimates are referred to as prospectively priced.

For 87 of the 100 cost estimates, prime contractors were able to achieve subcontract price reductions of \$42 million below the amounts negotiated in prime contract prices. The other 13 subcontract cost estimates had not been priced at the time of our review.

We believe the price reductions were achieved in large part because DOD contracting officers either did not require contractors to obtain subcontract cost or pricing data, evaluate the data, or provide the evaluation results prior to prime contract negotiations. Instead, DOD contracting officers used alternative pricing techniques to establish the reasonableness of subcontract estimates included in prime contract prices.

Although prime contractors substantially complied with the provisions of Public Law 87-653, ten prime contracts were overpriced by about \$7.4 million because prime contractors did not disclose updated subcontract pricing information to DOD contracting officers. DOD may be entitled to price reductions on these ten contracts under the provisions of Public Law 87-653.

In summary, our review of the pricing of major subcontracts disclosed that the safeguards intended to insure fair and reasonable prime contract prices were not effectively implemented.

Prospective subcontract cost or pricing data not obtained

The Federal Acquisition Regulation (FAR) provides that for prime contractors that are required to submit certified cost or pricing data pursuant to the Truth-in-Negotiations Act, Public Law 87-653, government contracting officers shall require the prime contractors to also obtain and submit prospective subcontract cost or pricing data in support of each subcontract cost estimate that is \$1 million or more, or both more than \$100,000 and more than 10 percent of the prime contractor's proposed price. The prime contractor is exempted from the requirement to obtain prospective subcontract cost or pricing data if the award is to be made on the basis of adequate price competition, established catalog or market prices, or prices set by law or regulations. This provision has been in the defense procurement regulations since 1970.

Of the 100 prospectively priced subcontracts, 20 were competitive and 80 were noncompetitive. For a majority of the 80 subcontract cost estimates, prime contractors obtained cost or pricing data from subcontractors prior to prime contract negotiations. However, prime contractors did not obtain cost or pricing data for 23 of the 80 subcontract estimates (29 percent). In 18 cases, prime contractors exempted subcontractors from submitting data because the estimates were misclassified as competitive. All of the misclassifications were made by FMC and Martin Marietta.

To illustrate, FMC misclassified 6 noncompetitive subcontract estimates amounting to \$23.6 million as competitive. FMC had received only one subcontract price quotation prior to prime contract negotiations, and did not obtain cost or pricing data from the prospective subcontractors. Accordingly, at the time of prime contract price negotiations, the DOD contracting officers had no assurance that the subcontract cost estimates based on single quotations and included in the proposed prime contract prices were fair and reasonable. FMC was able to negotiate about \$3.7 million in price reductions with the six subcontractors below the amounts included in prime contract prices.

Contracting officers did not obtain prime contractor or government evaluations of prospective subcontract price proposals

The Federal Acquisition Regulation provides that the prime contractor is responsible for the review and evaluation of prospective subcontract cost or pricing data, and for the submission of the evaluation results to the government contracting officer as part of the prime contractor's cost or pricing data submission. Also, the DOD contracting officer may request a government evaluation of a subcontract proposal under certain conditions, such as when the prime contractor's evaluation is not considered adequate. These provisions have been in the defense procurement regulations since 1972.

DOD contracting officers did not obtain prime contractor or government evaluations of subcontract proposals for 46 of 80 prospective subcontract cost estimates (58 percent). Therefore, contracting officers did not have sound bases for establishing prime contract prices. As discussed earlier, in 23 of the cases, evaluations were not done because prospective subcontract cost or pricing data was not obtained.

For the 80 prospectively priced subcontracts, prime contractors performed a total of 65 evaluations, however, 39 (or 60 percent) of these evaluations were completed after prime contract price negotiations and used by the prime contractors to negotiate lower prices with the subcontractors. Most of the evaluations performed after prime contract negotiations occurred at General Electric, FMC, General Dynamics, and Hercules. The delayed performance of subcontract proposal evaluations provided distinct opportunities for prime contractors to benefit from the negotiation of substantial price reductions with subcontractors.

To illustrate, under the 1982 Bradley Fighting Vehicle contract, a subcontractor proposed to provide a major subsystem to FMC at \$189.7 million. FMC reduced the proposed price to \$184.2 million in its proposal to the Army. Throughout prime contract negotiations, the Army contracting officer questioned

about the status of the subcontract proposal evaluation. FMC contended that the evaluation had not been completed and therefore was not available. The Army contracting officer further attempted to reserve the subcontract cost estimate for future pricing by including an estimate in the prime contract price subject to a downward adjustment at a later date. When agreement could not be reached, the Army contracting officer negotiated a reduction in the subcontract cost estimate to \$173 million in anticipation of the results of subcontract negotiations.

FMC had completed its subcontract proposal evaluation before prime contract negotiations but had not formalized the results in a published report until one day after prime contract negotiations. The FMC evaluation questioned a significant amount of costs proposed by the subcontractor. The FMC evaluation recommended a price range of \$158.6 to \$163.9 million. FMC was able to use the evaluation results to negotiate the subcontract price at \$167.9 million, or about \$5.1 million less than the cost estimate included in the prime contract price.

In another example, Hercules Aerospace Company conducted evaluations on 11 of 13 subcontract price proposals prior to negotiations on two Air Force prime contracts. The evaluations were essentially desk reviews of the price proposals and did not involve visits to the subcontractors' plants to validate the cost

or pricing data submissions. The evaluations questioned no costs on 9 of the 11 proposals and only \$335,000 on the other two proposals. The questioned costs were less than 1 percent of the proposed subcontract prices.

After the Air Force prime contract prices were negotiated, Hercules performed in-depth evaluations of the 13 price proposals at the subcontractors' plants. Hercules also obtained direct labor and indirect expense rate recommendations from DCAA on 11 of the subcontract proposals. These rate evaluations were completed after prime contract negotiations on 10 of the proposals, and were therefore of no direct benefit to the Air Force contracting officer in prime contract negotiations. Evaluations performed by Hercules questioned about \$16.5 million, or 23 percent of the \$69.5 million subcontract proposals. Hercules used the evaluation results to negotiate \$11.5 million in price reductions below the subcontract estimates negotiated in the prime contract prices.

The Air Force contracting officer used "decrement" factors² and desk reviews by Air Force technical personnel to establish negotiation objectives for the subcontract estimates included in the two prime contracts awarded to Hercules. Had in-depth

²A "decrement" factor is an estimated percentage price reduction that the prime contractor is expected to achieve in subcontract negotiations.

proposal evaluations and rate recommendations been made before prime contract negotiations and disclosed to the Air Force contracting officer, substantially lower prices should have been negotiated.

We believe that the nondisclosure of prime contractors' evaluation results on subcontract price proposals caused by either nonperformance, delayed performance, or misclassification of noncompetitive subcontract cost estimates constitutes a major weakness in prime contractors' cost estimating systems. I will discuss this condition and other estimating system weaknesses later in this statement.

Government contracting officers used alternative subcontract pricing techniques that were not as effective as subcontract proposal evaluations

When the results of prime contractor or government evaluations of subcontract price proposals are not provided or available, government contracting officers are faced with using "decrement" factors or other alternative pricing techniques to compensate for the missing subcontract proposal evaluations.

DOD contracting officers used alternative pricing techniques for assessing the reasonableness of 56 of the 80 prospective subcontract estimates (70 percent). These alternative pricing techniques reduced the subcontract cost estimates included in prime

contract prices. However, these pricing techniques are not adequate substitutes for in-depth evaluations of subcontract price proposals. Prime contractors consistently used the results of such evaluations to negotiate lower prices with subcontractors than DOD contracting officers achieved in prime contract negotiations by using alternative pricing techniques.

To illustrate, on a prime contract with Hercules the Air Force contracting officer used "decrement" factors to negotiate a \$2.9 million reduction applicable to six subcontract cost estimates amounting to \$27.9 million. After prime contract negotiations, Hercules was able to negotiate an additional reduction of \$2.4 million in subcontract negotiations through the use of proposal evaluation results completed after prime contract negotiations.

Prime contractors generally achieved substantial price reductions in subcontract negotiations--far in excess of the prime contract price reductions

When subcontract prices are negotiated after fixed-price prime contract awards, contractors have considerable financial incentives to negotiate lower prices than those included in the earlier negotiated prime contracts. As a result, there is a reluctance for prime contractors to conduct timely subcontract price proposal evaluations and to disclose the results to the DOD contracting officers.

Prime contractors reduced subcontract prices by about \$42 million (5.3 percent) below the estimates in the prime contracts for 87 prospective subcontracts. Twenty subcontracts were competitive and 67 were noncompetitive.

About \$39.3 of the \$42 million price reductions pertained to prospectively priced subcontracts at General Electric, FMC, General Dynamics, and Hercules. As indicated earlier, these four contractors completed evaluations on most subcontract price proposals after prime contract negotiations, and utilized the evaluation results to negotiate price reductions with their subcontractors. Subcontract price negotiations were also influenced by a number of other factors unknown at the time of prime contract negotiations. Therefore, we could not attribute the entire \$42 million exclusively to the use of subcontract evaluation results. We believe, however, that the prime contractors used the evaluations to negotiate substantial price reductions with their subcontractors. Had the prime contractors completed these evaluations before prime contract negotiations and disclosed the results to DOD contracting officers, similar reductions in prime contract prices should have been achieved.

The subcontract price reductions benefited the prime contractors exclusively on those subcontracts placed under firm fixed-price contracts. However, DOD also benefited from price

reductions on subcontracts placed under fixed-price incentive contracts. Of the \$42 million in subcontract price reductions, prime contract prices will also be reduced by about \$16.7 million reflecting the DOD cost sharing ratio under fixed-price incentive contracts. Therefore, the net benefit to the prime contractors is estimated at \$25.3 million.

Prime contract prices were increased because contractors did not disclose updated subcontract pricing information to the government

We identified overpricing of about \$7.4 million including overhead and profit because prime contractors did not disclose more current subcontract pricing information available prior to prime contract negotiations. Questionable pricing was identified on 30 subcontract cost estimates under 10 of the 26 prime contracts included in our review. Twenty-seven of the cost estimates were overpriced and three were underpriced. The net overpricing constitutes less than 1 percent of the \$1.5 billion in subcontract cost estimates included in our review.

In essence, prime contractors substantially complied with the provisions of Public Law 87-653 by disclosing the most recent subcontract price quotations, proposals, option prices, results of subcontract price negotiations, and purchase order prices available prior to prime contract negotiations. For those

subcontract cost estimates that were overstated by \$7.4 million in the prime contract prices, we intend to issue separate reports to the respective procuring offices recommending action to reduce the prime contract prices.

To illustrate the overpricing conditions identified during our review, FMC proposed to provide fire extinguisher assemblies under the Bradley Fighting Vehicle contract at \$864 a unit. The proposed unit price was based on an April 1983 price quotation from a prospective supplier. The Army contracting officer accepted the proposed price in prime contract negotiations completed on April 5, 1984. FMC received an updated price quotation of \$775 a unit from the prospective supplier in January 1984. A second prospective supplier also submitted a price quotation of \$595 a unit in January. The second supplier reduced its quoted price to \$500 a unit on April 2, 1984. None of the lower price quotations were disclosed to the Army contracting officer. As a result, the contract was overpriced by about \$437,000, or \$550,000 including overhead and profit. FMC subsequently purchased the fire extinguisher assemblies from the second supplier at \$500 a unit.

Another prime contractor, General Dynamics, proposed to provide an antenna assembly under a Standard Missile contract. The item was to be obtained from two suppliers. The weighted

average proposed unit price was \$1,935 based on September 1982 price quotations. The suppliers updated their proposed prices in June 1983 at \$1,849 and \$1,425 a unit. The updated proposals preceded prime contract negotiation which was concluded on July 28, 1983. The lower more current subcontract price proposals, however, were not disclosed to the Navy contracting officer. As a result, the Navy contract was overpriced by about \$233,000, or \$348,000 including add-on pricing factors and profit. General Dynamics subsequently purchased the antenna assemblies from the two suppliers at \$1,622 and \$1,325 a unit, respectively.

SURVEILLANCE OF CONTRACTOR COST ESTIMATING METHODS AND PRACTICES

Reliable and accurate contractor cost estimates are fundamental to negotiating fair and reasonable contract prices. Deficient estimating practices can, and do, cause excessively priced contracts. I just finished discussing a number of deficient estimating practices in subcontract pricing that resulted in contract prices higher than warranted. In many of these cases, the contractors substantially complied with the Truth-In-Negotiations Act by providing all factual data available. The prime contractors' estimating systems, however, did not develop important information bearing on the reasonableness of subcontract price estimates. When overpricing is caused by poor estimating, the government has no safeguard, such as P.L. 87-653, for reducing the contract prices.

DOD regulations require DCAA to establish and manage a regular program for reviewing contractor estimating methods. We reviewed DCAA's surveillance program to determine whether deficiencies in estimating practices were identified and resolved in a timely manner. We did not, however, independently assess the acceptability of contractor estimating systems.

DOD recognizes that sound and reliable estimating is the basis for good contract pricing. In a 1983 memorandum the Deputy Secretary of Defense emphasized to contracting officers that:

"A key element in the timely negotiation of a fair and reasonable price is to start with a well prepared and well documented contractor proposal. In this regard, we must ensure that contractor estimating systems are formalized and follow good estimating procedures * * *"

DOD's surveillance efforts, however, have not achieved that objective. We found that numerous estimating deficiencies remain unresolved. Also, since 1982, DCAA has routinely questioned in its proposal audits about 13 percent of the costs contractors estimated. In the agency's 1984 management year, these questionable costs totaled about \$24 billion. Further, we noted cases in which estimating deficiencies contributed to questionable costs.

We believe the cost estimating surveillance program suffers from a lack of:

- agreement among contractors, DCAA, and contracting officers about what constitutes an acceptable estimating system,
- clear direction for resolving deficiencies, and
- top management emphasis at all levels, including DCAA.

Resolution of deficiencies
is untimely

We found that DCAA has not uniformly achieved timely resolution of the estimating weaknesses they identify. Nine of the ten locations we visited had unresolved deficiencies when we completed our work. At four locations, deficiencies identified in 1981, or earlier, were still unresolved. Further, in a special study, DCAA identified 72 contractors where significant estimating deficiencies were unresolved at the end of 1984. Deficiencies at 21 contractors had been outstanding for over 2 years.

Achieving prompt resolution of estimating deficiencies is important because the weaknesses the auditors identify can affect significant amounts of proposed costs. For example, at the Boeing Aerospace Company, DCAA determined that the

contractor did not develop cost data to support its estimates of "material growth"--a catch-all factor representing various additions to base material costs. The ACO at this location identified a group of six proposals on which the company had estimated a total of \$59.8 million in "material growth" costs. In reviewing these proposals, DCAA allowed some material growth costs in the absence of better data, and questioned about \$40 million. Government negotiators ultimately allowed about \$18 million of the costs DCAA had questioned.

At Martin Marietta, DCAA determined that the company did not provide adequate data to support estimated costs of design changes in proposed material. The company proposed rates up to 10 percent of material costs, but a study DCAA conducted indicated that the company experienced costs averaging less than 1 percent. On a group of four proposals, the company estimated these costs at about \$54.4 million, and in reviewing the proposals, DCAA questioned the estimates in total. Government negotiators ultimately allowed about \$43 million in design change costs. One negotiator, who allowed a 5 percent factor for design changes, said that the cost was likely to be incurred even though supporting data was lacking.

Elements of an acceptable cost
estimating system are not
well defined

Procurement regulations do not precisely define what are acceptable estimating practices. Instead, the regulations only discuss the benefits derived from the use of good estimating practices, the rationale for conducting estimating system reviews, and a few broad categories that the auditor should consider in determining the acceptability of a contractor's estimating system.

Because the regulations are not precise, contracting officers and DCAA must use considerable judgment in deciding what are estimating deficiencies. Often, contractors do not agree with the DCAA's judgment and are reluctant to use estimating methods they believe procurement regulations do not require. Divergent views among contractors, contracting officers, and DCAA regarding what constitutes acceptable estimating methods, we believe, has resulted in deficiencies not being identified and resolved in a timely manner.

For example, the DCAA auditors at General Electric and FMC reported that inadequate subcontract proposal evaluations constituted an estimating deficiency. In contrast, DCAA did not examine this area at General Dynamics in its estimating reviews, although the ACO asked the auditors to review it. During our

subcontract pricing work, we found weaknesses at General Dynamics in the area of subcontract evaluations. We brought this matter to the company's attention. However, at this time action has not been taken to strengthen their policies on providing subcontract cost evaluations to contracting officers. We believe that, had DCAA followed up on the ACO's request, this estimating weakness would have been identified for corrective action earlier.

During the subcontract review, we identified seven prospectively priced noncompetitive subcontracts that General Dynamics had estimated at \$44.1 million. Using various other pricing techniques, DOD contracting officers accepted a value of \$39.4 million for the seven subcontracts. Using evaluation reports that were not made available to the contracting officer, the company negotiated prices totalling \$38 million for the seven subcontracts, or about \$1.4 million less than DOD contracting officers accepted.

Responsibility for resolving
estimating deficiencies is unclear

Procurement regulations provide that where estimating system deficiencies continue to exist and have an adverse effect on prices, the problem should be brought to the attention of procurement officials at a level necessary to bring about corrective action. However, the regulations do not identify which procurement officials are responsible for resolving estimating

system deficiencies. This regulatory gap has created differences of opinion within DOD agencies as to who is responsible for resolving estimating system deficiencies.

At several of the locations we visited, the resident administrative contracting officer (ACO) had accepted responsibility for resolving estimating deficiencies. But at four locations, ACOs relied on either DCAA or the procuring contracting officers from buying activities to resolve estimating deficiencies. Several ACOs doubted their regulatory authority for resolving deficiencies. Because there is no requirement that an acceptable cost estimating system be a precondition to contract with the government, there is no contractual mechanism available to motivate contractors to correct estimating deficiencies such as withholding payments on existing contracts.

We found that the procuring contracting officers we talked to at the buying activities--those who negotiate and award most major contracts--did not accept this responsibility. Procuring contracting officers are generally more concerned about the final pricing of discrete contract actions and not with systemic pricing practices in prime contractors' plants. Generally, procuring contracting officers believed that the adverse effects of estimating deficiencies are mitigated by the DCAA's review of individual price proposals. We strongly disagree with this

position. Uncorrected deficiencies cause DCAA to spend unnecessary time reviewing inadequately prepared and poorly supported cost proposals. And, more important, costs questioned by DCAA are frequently not upheld in negotiations. Thus, we believe uncorrected estimating system deficiencies can and do result in the negotiation of higher prices.

Contract auditor surveillance activities need improvement

We reviewed DCAA's estimating surveillance activities from July 1981 to June 1985. We found that DCAA devoted varying levels of effort to estimating reviews; generally had not conducted in-depth reviews covering all aspects of contractors' estimating systems since the late 1960s and early 1970s; and, normally did not involve technical personnel as part of the evaluation team.

DCAA relied primarily on reviews of individual price proposals to surface estimating deficiencies. Contract administration officials at some locations questioned the effectiveness of this approach. We likewise question the approach and believe it limits the effectiveness of DOD surveillance activities.

DCAA is reluctant to devote a large amount of resources to estimating system reviews because of competing demands for their time. Recognizing this, DCAA revised its procedures in 1982 to

enable the real-time reporting of estimating deficiencies. Real-time reports are prepared when DCAA identifies an estimating deficiency during price proposal audits. DCAA believed that the real-time reporting of estimating deficiencies coupled with periodic in-depth analyses of estimating practices would improve proposal submissions and correspondingly reduce audit effort.

Most of the reports issued at the locations we visited were real-time reports based on deficiencies identified during proposal audits. Real-time reporting, however, was not "coupled" with in-depth analyses. We found that DCAA was issuing real-time reports instead of conducting in-depth analyses. We believe real-time reporting limits DCAA's ability to comment on the soundness or reliability of the estimating system because the reports deal with isolated instances of problems and do not identify the underlying causes or the dollar impact of the deficiencies.

Real-time reporting also does not provide for involving technical personnel in evaluating contractor estimating practices. Technical participation in estimating surveillance at the locations we visited was generally limited. Technical participation in estimating surveillance can, however, significantly contribute to the auditor's ability to identify inadequate estimating methods. Technical personnel at Martin

Marietta, for example, identified a number of estimating practices they considered unacceptable. One involved the company's practice of estimating supervisory time at 20 percent of manufacturing labor hours for certain proposals without providing support for the factor. Industry standards indicated a 10 percent factor would be more reasonable. Because DCAA did not ask about weaknesses technical personnel identified, they did not surface these problems in their estimating surveillance reports.

DOD managers have recently recognized that more attention needs to be devoted to in-depth estimating reviews. In July 1985, the Defense Logistics Agency's Director for Contract Management instructed the agency's contract administration activities to request formal estimating reviews at locations where formal reviews have not been performed recently. Similarly, DCAA reemphasized in a May 1985 memorandum that the real-time reporting policy did not negate requirements for periodic in-depth analysis of estimating practices.

GAO agrees that more in-depth analysis of contractor estimating practices is needed. Because the program as currently structured has not received the attention and priority needed to provide effective surveillance, we believe the Secretary of Defense should assure that appropriate officials provide the oversight needed to strengthen DCAA's surveillance efforts.

These officials should further assure that a framework for defining acceptable cost estimating methodologies is developed, and that regulatory guidance on roles and responsibilities for resolving estimating deficiencies is clarified.

CONTRACTOR OVERHEAD COSTS

In my July 1984 testimony before this subcommittee, I discussed the need to strengthen the criteria governing the allowability of defense contractors' public relations costs. The information I presented during that hearing was based on final overhead cost settlements at 12 contractor locations. Our work showed there were numerous instances where DCAA challenged significant amounts of contractor overhead costs as unallowable, but ACOs were nevertheless allowing about 50 percent of the costs questioned. At the 12 contractor locations, \$31 million of costs challenged by DCAA were introduced into negotiations. ACOs allowed \$16.5 million into overhead.

Our recently completed review of overhead settlements at seven contractor locations disclosed that ACOs allowed about 57 percent of the costs challenged by DCAA as unallowable. Of the \$17.1 million questioned as unallowable, \$9.7 million was allowed. The final overhead settlements at the seven locations were concluded between February 1983 and March 1985. Attachment II provides the details of the overhead settlements at each location.

Regulations regarding allowable overhead costs are not clear

Costs challenged by DCAA are not being upheld in negotiations, in large part, because contractors, contracting officers, and contract auditors have different interpretations regarding what costs are allowable. The differing interpretations, we believe, are caused by ambiguities and loopholes in the procurement regulations which deal with overhead costs.

To illustrate, DCAA at Raytheon questioned \$66,000 on the basis that the costs were contributions and donations. Procurement regulations state that "Contributions and donations are unallowable." Our review of the negotiation memoranda and other documents disclosed that the auditors challenged the costs because (1) recipients of the funds were listed by the Internal Revenue Service as charitable organizations, (2) Raytheon's invoice for one expense identified the payment as a "contribution", and (3) some expenses were for developing a public announcement on boating safety. The ACO disagreed with DCAA and allowed \$33,000 because he believed some of the costs were reasonable business expenses and had been allowed in prior overhead settlements. Differing interpretations such as this are routine in settling overhead costs. Until the ambiguities and loopholes in existing procurement regulations are removed, such situations will continue.

Actions to improve overhead
cost settlements

Your hearings were the precursor of two later congressional hearings which focused on the need to improve DOD's system to prevent payment of unallowable overhead costs. Because of the congressional concern and extensive publicity surrounding overhead cost settlements, there are actions underway, by both contractors and DOD, to improve overhead cost settlements. For example, we observed that several contractors (General Electric, Hercules, and RCA) are making a more concerted effort to screen their overhead costs before submitting final proposals. Some contractors have also withdrawn overhead proposals that had been submitted but not yet settled in order to screen them for questionable overhead costs.

After your hearings last year we made two recommendations to the Secretary of Defense in October 1984 concerning public relations costs. In February 1985 a proposed change to FAR was circulated for comment. The proposed FAR change we reviewed would add coverage on public relations costs to the existing coverage on advertising and define certain public relations activities whose costs are either allowable or unallowable. This change is a positive step and should eliminate much of the confusion concerning these costs. This revision has not yet become effective but, according to DOD officials, it should be promulgated in the FAR shortly.

We recommended also in May 1985 that the Secretary of Defense:

--Amend FAR to state that all costs made specifically unallowable under any FAR section are not made allowable under any other section.

--Direct ACOs to negotiate, settle, and document costs questioned by DCAA on an item-by-item basis.

On September 18, 1985, DOD concurred with our first recommendation and partially concurred with the latter recommendation on the premise that individual cost elements need not be negotiated and settled on an item-by-item basis. According to DOD, each cost element should be discussed and tracked to negotiation memoranda. Nevertheless, we continue to believe that our recommendation that the government negotiate and settle costs on an item-by-item basis would contribute significantly to the effectiveness of Cost Accounting Standard 405, "Accounting for Unallowable Costs" and would eliminate many of the same unallowable costs which are proposed each year.

DOD has initiated a number of actions to improve overhead cost settlements. On August 5, 1985, the Deputy Secretary of Defense assigned responsibility for overhead cost settlements to the DCAA. This means overhead cost settlements will be based on

auditor determination procedures yet to be developed rather than being negotiated by administrative contracting officers. In addition, the Defense Council on Integrity and Management Improvement directed that a task force be established to review the procurement regulations covering overhead costs to identify ambiguities and loopholes. The task force is expected to complete its review by December 1985. Based on the results of this effort, changes in the regulations may be made.

GAO is pleased to see contractors and the DOD seeking ways to improve overhead cost settlements. We believe the initiative to eliminate ambiguities and loopholes in procurement regulations is particularly important. The more quickly DOD moves to clarify the regulations, the more quickly differences among contractors, DCAA, and ACOs will be resolved. These initiatives should lead to improvements in the overhead settlement process. However, until specific action is taken and concrete proposals are developed, we will reserve judgment on their effectiveness.

Mr. Chairman, that concludes my statement. I will be pleased to answer any questions you have.

CONTRACTOR LOCATIONS VISITED

General Electric Corp.,
Aircraft Engine Business
Group
Evendale, Ohio

Martin Marietta Corp.,
Orlando Aerospace
Orlando, Florida

McDonnell Douglas Corp.,
McDonnell Aircraft
Company
St. Louis, Missouri

Raytheon Company
Missile Systems Division
Bedford, Massachusetts

RCA Corp.,
Government Communications
Systems
Camden, New Jersey

Missile and Surface Radar
Moorestown, New Jersey

The Boeing Company
Boeing Aerospace Company
Seattle, Washington

FMC Corporation
Ordnance Division
Operations
San Jose, California

General Dynamics Corp.,
Pomona Division
Pomona, California

Hercules Inc.,
Hercules Aerospace Co.,
Bacchus Works
Magna, Utah

Texas Instruments
Equipment Group
Dallas, Texas

SUMMARY SCHEDULE OF SEVEN CONTRACTORS' OVERHEAD
COSTS QUESTIONED BY DCAA AND THEIR RESOLUTION
BY ACOs

<u>CONTRACTOR</u>	<u>QUESTIONED BY DCAA & NEGOTIA- TED BY ACO</u>	<u>RESULTS OF NEGOTIATIONS</u>		<u>PERCENT ALLOWED</u>
		<u>ALLOWED</u>	<u>DISALLOWED</u>	
FMC				
- Ordnance Division Operations	\$ 549,810	\$ 324,810	\$ 225,000	59.1
General Electric				
- Aircraft Engine Business Group	6,401,726	4,775,375	1,626,851	74.6
Hercules Aerospace Company				
- Bacchus Works	1,284,318	995,377	288,941	77.5
Martin Marietta Corporation				
- Orlando Aerospace	1,319,261	728,190	591,071	55.2
RCA				
- Aerospace and Defense	877,498	292,918	584,580	33.4
Raytheon Company				
- Executive Offices	2,459,952	1,626,468	833,484	66.1
Texas Instruments				
- Equipment Group				
- Corporate Research, Development, and Engineering	<u>4,198,000</u>	<u>1,025,000</u>	<u>3,173,000</u>	<u>24.4</u>
 TOTAL	 <u>\$17,090,565</u>	 <u>\$9,768,138</u>	 <u>\$7,322,427</u>	 <u>57.1</u>

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