

GAO

Report to the Chairman, Legislation and
National Security Subcommittee,
Committee on Government Operations,
House of Representatives

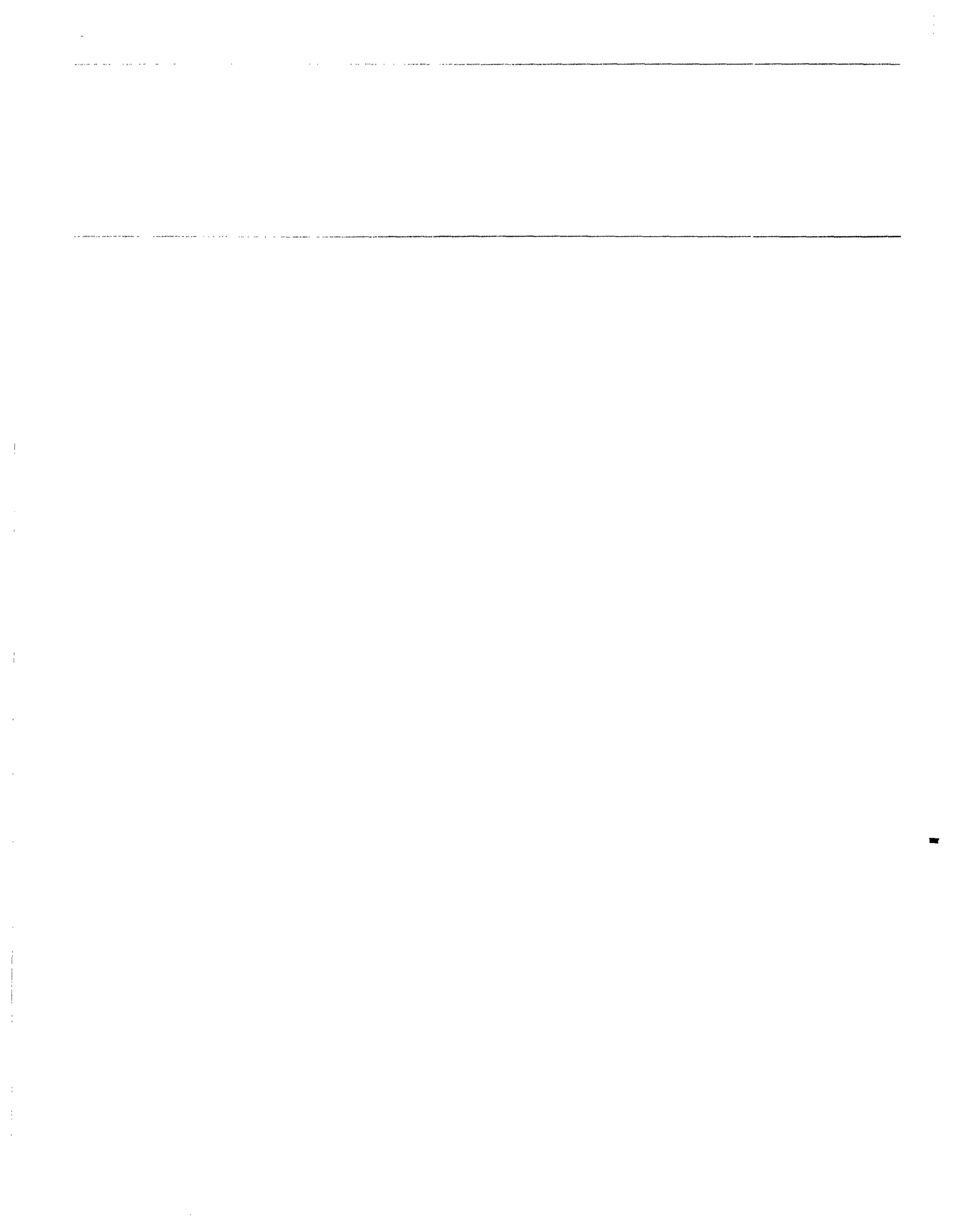
November 1992

CONTRACT PRICING

A Low Percentage of Contractors Are Responsible for Most Reported Defective Pricing



148181





United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-242859

November 24, 1992

The Honorable John Conyers, Jr.
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your request for additional information about defective pricing on Department of Defense (DOD) contracts. In May 1992 we reported to you that audits conducted by the Defense Contract Audit Agency (DCAA) identified \$3 billion in defective pricing in fiscal years 1987-90.¹ In a related report issued that month, we reported that relatively few contractors were responsible for most defective pricing.²

We are providing information that updates the amount of defective pricing found in audits conducted by DCAA through fiscal year 1991, and shows the percentage of contractors responsible for the defective pricing reported in fiscal years 1990-91. As agreed with your office, we are also providing a list of the contractors that were responsible for most of the defective pricing in fiscal years 1990 and 1991.

Background

Contracts exceeding a total of \$443 billion were examined by DCAA for defective pricing during fiscal years 1987-91. Because there is only one supplier for many of DOD's needs, those needs are contracted for noncompetitively. Prices for noncompetitive contracts are generally determined through extensive negotiations. For competitively awarded contracts, it is assumed that market forces result in fair and reasonable contract prices.

Recognizing the government's vulnerability in noncompetitive contracting situations, the Congress passed the Truth in Negotiations Act in 1962 to protect the government against overstated contract prices. As amended, the act requires that offerors for prime and subcontracts submit cost or pricing data supporting their proposed prices above certain thresholds and certify that the data submitted are accurate, complete, and current.

¹Contract Pricing: Issues Related to the Defense Contract Audit Agency (GAO/NSIAD-92-188, May 6, 1992).

²Contract Pricing: Status of Defective Pricing (GAO/NSIAD-92-184FS, May 21, 1992).

Contracts are considered to be defectively priced when (1) a contractor negotiating a price for a noncompetitive contract does not submit accurate, complete, or current data about the costs included in its proposal; (2) the government contracting officer relies on the defective data; and (3) as a result of the use of this data, the contract price is increased. If defective pricing is found, the government has a right to recover, with interest, the amount of the increase. If a contractor knowingly submits defective data, an additional penalty is assessed equal to the unwarranted increase in the contract price.

DCAA defective pricing audits result in recommended price adjustments to contract prices. Before establishing a government position on a DCAA report's recommendations, the DOD contracting officer reviews the auditor's report, obtains a response from the contractor on the audit issues, and consults legal and technical advisers. The contracting officer then negotiates a settlement with the contractor or, failing to reach agreement on the defective pricing, issues a final decision to the contractor pursuant to the disputes clause of the contract. The audit report is closed when the contractor has taken the corrective actions (including refunding or crediting negotiated price adjustments) deemed necessary by the contracting officer. Historically, DOD has sustained about half of the contract price adjustments recommended by DCAA.

DCAA determines which contracts to audit through its annual assessment of the risk that major contractors pose for defective pricing. For fiscal year 1992, DCAA used four factors to assess contractor risk: (1) estimating system deficiencies, (2) accounting system deficiencies, (3) incidence of defective pricing, and (4) amount of contract price adjustment recommended by DCAA.³

Results in Brief

Defective pricing is a persistent problem that has caused contract prices to be overstated by billions of dollars. DCAA audited contracts totaling \$443 billion in fiscal years 1987-91 and reported \$3.67 billion in defective pricing.

Our analysis of DCAA's data shows that defective pricing is concentrated in a small percentage of contractors. For the 5-year period, about 6 percent of the contractors audited accounted for 80 percent of the defective pricing DCAA reported. For fiscal years 1990-91, our analysis shows that

³For further discussion of DCAA's contractor assessment procedures see Contract Pricing: DCAA's Methodology Change in Identifying "High Risk" Contractors (GAO/NSIAD-92-183, June 2, 1992).

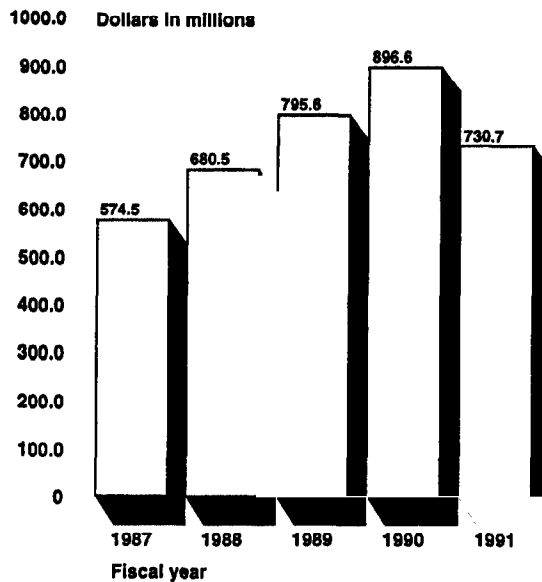
about 7 percent of the contractors audited accounted for 86 percent of the defective pricing DCAA reported. These contractors are listed in appendixes I and II.

Defective Pricing Has Been a Persistent Problem Involving Billions of Dollars

Between fiscal years 1987 and 1991, DCAA completed 8,566 prime contract audits; 3,048 (36 percent of these audits) identified \$2.31 billion in prime contract defective pricing. DCAA completed 2,795 subcontract defective pricing audits during the 5-year period, and 1,053 (38 percent) identified \$1.36 billion in subcontract defective pricing. Overall, for both prime contract and subcontract audits, defective pricing totaled \$3.67 billion for the 5-year period.

As shown in figure 1, the defective pricing reported by DCAA increased from \$574.5 million in fiscal year 1987 to \$896.6 million in fiscal year 1990. In fiscal year 1991, the defective pricing reported by DCAA declined to \$730.7 million.⁴

Figure 1: Defective Pricing Trends



Source: GAO analysis of DCAA data.

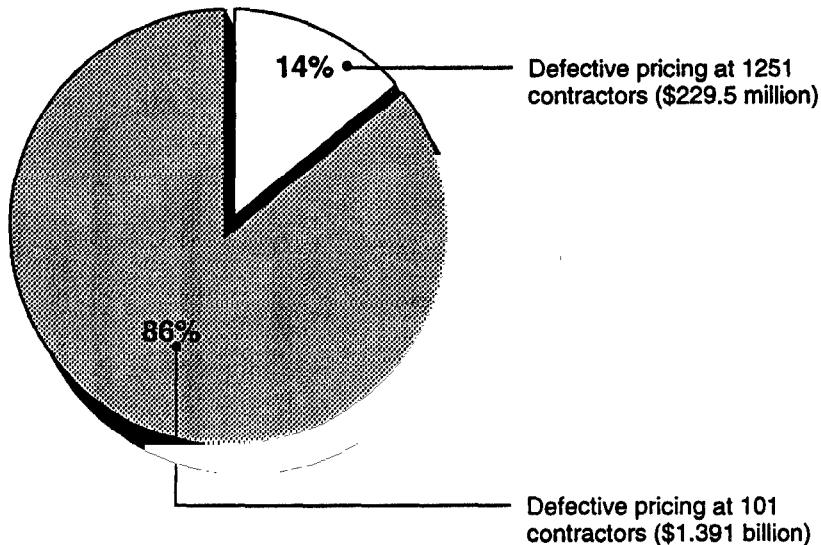
⁴For additional details on defective pricing during this period see Contract Pricing: Status of Defective Pricing (GAO/NSIAD-92-184FS, May 21, 1992).

A Low Percentage of Contractors Are Responsible for Most Reported Defective Pricing

Despite the existence of the Truth in Negotiations Act, defective pricing in both prime contracts and subcontracts has caused contract prices to be overstated by billions of dollars. When contractors benefit from these overstated prices, the taxpayer ultimately pays the bill. For the 5 fiscal years, 1987-91, 116 contractors—about 6 percent of the contractors audited—accounted for 80 percent of the \$3.67 billion in defective pricing reported by DCAA.

In fiscal years 1990-91, DCAA audited 1,352 contractors and reported over \$1.6 billion in defective pricing. About 7 percent of this group (101 contractors) accounted for 86 percent of the defective pricing DCAA reported. (See fig. 2.) Appendixes I and II list the contractors in descending order of the amount of reported defective pricing; the lists are limited to those contractors responsible for the majority of defective pricing in fiscal years 1990 and 1991, respectively.⁵ The far right column of the appendixes shows the defective pricing reported by DCAA as a percentage of the value of the contracts DCAA audited at the contractor.

Figure 2: Relatively Few Contractors Are Responsible for Most of the Defective Pricing Reported in Fiscal Years 1990-91



Source: GAO analysis of DCAA data.

⁵The number of contractors listed in each appendix (72 in appendix I and 52 in appendix II) adds to more than 101 because some contractors appear on the list in both years. The total of 101 represents an unduplicated count.

The percentage reported in the far right column of the appendixes should not be used as a relative measure for determining whether a contractor is considered high risk. Rather, the percentage is provided (1) to place the defective pricing reported by DCAA into perspective in relation to the total value of the contracts audited by DCAA and (2) to demonstrate the significance of defective pricing problems found by DCAA.

Scope and Methodology

Our universe of contractors was developed from DCAA's data base of defective pricing audits that were completed between October 1989 and September 1991 and that covered contracts totaling \$100,000 or more. The data analyzed for the appendixes of this letter were reported in DCAA's data base at the end of fiscal years 1990 and 1991. The data are subject to revision by DCAA because of follow-up audits and additional fact finding.

Because we relied on DCAA's automated information system to support our audit objectives, we evaluated and selectively tested controls over the data. Our testing of fiscal year 1990 data did not identify significant data accuracy problems, although we identified some minor internal control weaknesses. For the fiscal year 1991 data, we identified through selective testing a number of input errors in DCAA's data base that we were able to correct before performing our analyses. Therefore, we believe the data are sufficiently usable for our audit efforts.

We determined those contractors with the greatest reported defective pricing using DCAA's system of field office and contractor codes. We identified contractors responsible for 80 percent of the defective pricing reported in fiscal year 1990 and 89 percent of that reported in fiscal year 1991. We used this higher percentage for fiscal year 1991 because defective pricing reported in that year was particularly concentrated in 4 audits, which together accounted for 47 percent of the defective pricing reported. Some contractors with significant amounts of defective pricing would have been excluded from our fiscal year 1991 list had we used the 80 percent cutoff. Therefore, we expanded the fiscal year 1991 list to include contractors accounting for 89 percent of all reported defective pricing.

Because DCAA changes its codes when contractor ownership and organization change, we verified the accuracy of contractor codes and names with DCAA's field offices and made corrections where appropriate. Where contractor ownership or names have recently changed, we show both the current and former names. The amount of defective pricing shown

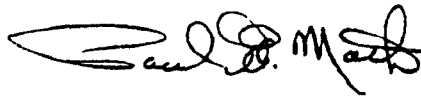
is that which appears in DCAA's data base for fiscal years 1990 and 1991, although the data may have been revised in subsequent supplemental reports.

As arranged with your office, we did not obtain fully coordinated DOD comments on this report. However, we discussed it with agency officials. While they agreed with the facts we have presented, they were concerned that the facts may be misinterpreted if additional explanation of the data was not provided. We have, therefore, provided additional explanations where appropriate. We conducted our work between June and August 1992 in accordance with generally accepted government auditing standards.

Unless you announce its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; the Director, Office of Management and Budget; and other interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202)275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix III.

Sincerely yours,



Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

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Abbreviations

DCAA Defense Contract Audit Agency
DOD Department of Defense

Contractors Accounting for 80 Percent of All Defective Pricing Reported by DCAA in Fiscal Year 1990

Contractor ^a	Defective pricing reported	
	Amount (in thousands of dollars) ^b	As a percentage of the value of the contracts DCAA audited at the contractor ^c
United Technologies Corporation		
Pratt and Whitney Government Engines Space Propulsion Division	\$8,530	0.28
Hamilton Standard Space and Sea Systems	11,909	9.09
Pratt and Whitney—Manufacturing Operations	57,936	4.17
Sikorsky Aircraft Division	4,731	0.30
Subtotal	\$83,106	1.35
CAE-Link Incorporated, Binghamton Operations (formerly Link Flight Simulation Division)	62,284	10.99
The Boeing Company		
Boeing Computer Support Services— Integrated Information Services	32,844	21.10
Boeing Defense and Space Group, Products Support Division (formerly Boeing Military Airplanes, Wichita)	20,694	2.07
Boeing Defense and Space Group, Electronics Systems Division (formerly Boeing Aerospace and Electronics)	5,048	0.44
Subtotal	58,586	2.55
Rockwell International Corporation		
Collins Avionics Communications Division	5,994	1.25
North American Aircraft	22,711	0.44
Space Transportation Systems Division	8,889	0.53
Rocketdyne Division	13,107	0.47
Subtotal	50,701	0.51
General Electric Company		
Aircraft Engines, Lynn	22,150	1.92
General Electric Aerospace Group, Simulation and Control Systems Department	3,503	7.14
General Electric Aerospace Group, Electronic Systems Department	6,472	4.06

(continued)

**Appendix I
Contractors Accounting for 80 Percent of All
Defective Pricing Reported by DCAA in Fiscal
Year 1990**

Contractor ^a	Defective pricing reported	
	Amount (in thousands of dollars) ^b	As a percentage of the value of the contracts DCAA audited at the contractor ^c
General Electric Aerospace Group, Defense Systems Department	2,782	0.51
General Electric Aerospace Group, Government Electronic Systems Division	5,929	0.60
Subtotal	\$40,836	1.41
Raytheon Company		
Submarine Signal Division	5,727	3.02
Missile Systems Division, Andover	9,091	1.25
Missile Systems Division, Lowell	4,252	0.49
Equipment Development Division, Equipment Development Laboratories	9,390	0.59
Electromagnetic Systems Division	4,525	0.96
Subtotal	32,985	0.86
Teledyne Industries, Incorporated		
Teledyne Ryan Electronics	3,120	9.21
Teledyne Ryan Aeronautical Division	7,912	2.75
Teledyne Systems Company, Incorporated	20,736	8.11
Subtotal	31,768	5.51
Northrop Corporation, Aircraft Division	30,809	1.26
Westinghouse Electric Corporation		
Aerospace and Electronics Systems Division	14,515	1.01
Integrated Logistics Support Division	8,826	2.70
Marine Division	4,763	1.05
Subtotal	28,104	1.26
Hercules, Incorporated, Hercules Aerospace Company, Bacchus Plant	26,867	4.71
General Motors-Hughes Electronics Corporation		
Hughes Aircraft Company, Missile Systems Group	5,881	0.43
Hughes Aircraft Company, Radar Systems Group	3,421	0.32
Hughes Aircraft Company, Electro- Optical and Data Systems Group	9,215	0.40
Subtotal	18,517	0.39
McDonnell Douglas Corporation		
McDonnell Douglas Missile Systems	\$2,977	2.60

(continued)

**Appendix I
Contractors Accounting for 80 Percent of All
Defective Pricing Reported by DCAA in Fiscal
Year 1990**

Contractor ^a	Defective pricing reported	
	Amount (in thousands of dollars) ^b	As a percentage of the value of the contracts DCAA audited at the contractor ^c
McDonnell Aircraft Company	\$3,336	0.06
McDonnell Douglas Helicopter Company	12,137	0.77
Subtotal	\$18,450	0.27
Motorola, Incorporated		
Government Electronics Group	14,619	4.00
Codex Corporation	3,564	29.60
Subtotal	18,183	4.81
Orbital Sciences Corporation	16,389	19.31
Rohr, Incorporated (formerly Rohr Industries)	15,670	3.62
Martin Marietta Corporation, Martin Marietta Electronics, Information, and Missiles Group	15,513	0.54
Litton Systems, Incorporated, Applied Technology Division	14,857	4.27
AT&T Federal Systems Business Unit	14,142	4.08
General Dynamics Corporation		
Fort Worth Division	2,921	0.17
Convair Division	2,667	0.45
Air Defense Systems Division, Pomona	4,511	0.41
Air Defense Systems Division, Rancho Cucamonga (formerly Valley Systems Division)	3,076	0.67
Subtotal	13,175	0.34
FMC Corporation, Ground Systems Division	12,179	4.00
Loral Aerospace Corporation, Aeronutronic Division (formerly Ford Aerospace Corporation, Ford Aeronutronics Division)	10,911	2.28
IBM		
Federal Systems Company, Owego	4,861	0.75
Federal Systems Company, Manassas	5,512	1.87
Subtotal	10,373	1.10
Honeywell, Incorporated, Space Systems Group, Space and Strategic Systems Operation	10,136	4.54

(continued)

**Appendix I
Contractors Accounting for 80 Percent of All
Defective Pricing Reported by DCAA in Fiscal
Year 1990**

Contractor^a	Defective pricing reported	
	Amount (in thousands of dollars)^b	As a percentage of the value of the contracts DCAA audited at the contractor^c
Israel Aircraft Industries, Limited	\$ 9,779	2.97
Partner's National Health Plan	6,829	5.48
Electrocom Automation, Incorporated	4,705	5.95
Lockheed Missiles and Space Company, Incorporated	4,687	0.24
Norris Industries, Incorporated, Vernon Division	4,022	1.12
Allied-Signal Aerospace Company, Garrett Fluid System Division	3,937	2.03
TRW, Incorporated, Space and Defense Sector, Space and Technology Group	3,627	1.25
Thiokol Corporation, Strategic Operations Division	3,483	1.00
United Engineers and Constructors, Incorporated	3,465	4.96
Sundstrand Corporation, Sundstrand Power Systems (formerly Sundstrand Turbomach)	3,367	8.78
Atlantic Research Corporation, Aerospace Group	3,289	3.27
Aircraft Gear Corporation	3,250	7.05
Aerojet Propulsion Division (formerly Aerojet Techsystems Company)	3,211	1.41
General Motors Corporation, DELCO Systems Operations	3,144	1.76
Katema, Incorporated, Aerospace and Electronics Division	3,048	25.37
Tusas Aerospace Industries, Incorporated	3,010	0.89
Precision Cast Parts Corporation	2,882	20.40
Datron Systems, Incorporated	2,730	31.69
Nero and Associates, Incorporated	2,699	6.79
Fenn Manufacturing Company (a subsidiary of United Dominion Industries)	2,635	14.97
Total	\$712,340	1.22

^aConsistent with DCAA's practice, each company unit is listed as a separate contractor.

^bThese amounts represent the total contract price adjustments recommended by DCAA as of the end of the fiscal year. The amount of these recommended price adjustments may change subsequent to the end of the fiscal year due to follow-up audits and additional fact finding.

^cThese percentages represent the ratios of recommended contract price adjustments to the total dollar value of the contracts audited at each contractor.

Contractors Accounting for 89 Percent of All Defective Pricing Reported by DCAA in Fiscal Year 1991

Contractor ^a	Defective pricing reported	
	Amount (in thousands of dollars) ^b	As a percentage of the value of the contracts DCAA audited at the contractor ^c
United Technologies Corporation		
Pratt and Whitney Government Engines Space Propulsion Division	\$ 6,654	0.54
Hamilton Standard, Aircraft Products Department	11,756	8.67
Pratt and Whitney—Manufacturing Operations	388,530	6.64
Sikorsky Aircraft Division	4,584	0.55
Subtotal	\$411,524	5.11
CAE-Link, Incorporated, Binghamton Operations (formerly Link Flight Simulation Division)	24,884	5.96
General Motors-Hughes Electronics Corporation		
Hughes Aircraft Company, Missile Systems Group	13,459	3.59
Hughes Aircraft Company, Radar Systems Group	7,120	0.74
Subtotal	20,579	1.54
Rockwell International Corporation		
North American Aircraft	4,293	2.04
Rocketdyne Division	12,668	0.61
Subtotal	16,961	0.74
General Electric Company		
Aircraft Engines, Evendale Plant	3,293	0.50
Aircraft Engines, Lynn	5,392	0.33
General Electric Aerospace, Government Electronic Systems Division	7,695	1.09
Subtotal	16,380	0.54
The Boeing Company		
Boeing Defense and Space Group, Products Support Division (formerly Boeing Military Airplanes, Wichita)	2,611	2.62
Boeing Defense and Space Group, Helicopter Division (formerly Boeing Helicopters)	2,904	1.39

(continued)

Appendix II
Contractors Accounting for 89 Percent of All
Defective Pricing Reported by DCAA in Fiscal
Year 1991

Contractor^a	Defective pricing reported	
	Amount (In thousands of dollars)^b	As a percentage of the value of the contracts DCAA audited at the contractor^c
Boeing Defense and Space Group, Military Airplane Division (formerly Boeing Military Airplanes, Seattle)	\$6,674	1.97
Subtotal	\$12,189	1.88
Raytheon Company		
Submarine Signal Division	9,161	2.54
Missile Systems Division	1,963	0.77
Subtotal	11,124	1.80
Marvin Engineering Company, Incorporated	10,854	27.18
Textron, Incorporated, Fuel Systems Textron (formerly Excello Corporation, Fuel Systems Division)	10,609	19.39
Allied-Signal Aerospace Company		
Bendix Engine Controls Division	6,959	3.56
Bendix Communications Division	3,399	5.33
Subtotal	10,358	3.99
General Dynamics Corporation		
Electric Boat Division	2,940	0.47
Fort Worth Division	4,709	0.68
Subtotal	7,649	0.58
Varian Associates, Incorporated, Microwave Tube Division (now split into Traveling Wave Tube Products, Microwave Power Tube Products, and Coupled Cavity Tube Products)	7,336	15.17
Honeywell, Incorporated, Space Systems Group, Space and Strategic Systems Operation	7,144	1.39
Sundstrand Corporation, Sundstrand Power Systems	6,847	6.18
Martin Marietta Corporation, Martin Marietta Astronautics Group	6,289	0.45
McDonnell Douglas Corporation		
McDonnell Aircraft Company	2,538	0.16
McDonnell Douglas Helicopter Company	3,396	1.41
Subtotal	5,934	0.33

(continued)

Appendix II
Contractors Accounting for 89 Percent of All
Defective Pricing Reported by DCAA in Fiscal
Year 1991

Contractor^a	Defective pricing reported	
	Amount (in thousands of dollars)^b	As a percentage of the value of the contracts DCAA audited at the contractor^c
Teledyne Industries, Incorporated		
Teledyne Ryan Electronics	\$2,838	20.02
Teledyne Systems Company, Incorporated	2,174	2.54
Subtotal	\$5,012	5.02
Lockheed Aeronautical Systems Company	4,968	3.23
Archetype Services (a joint venture of Cobarc Services and Professional Services, Unlimited)	4,651	20.57
Grumman Aerospace Corporation, Aircraft Systems Division	4,321	0.28
TRW Incorporated, Space and Defense Sector, Space and Technology Group	4,005	0.15
E-Systems, Incorporated, Greenville Division	3,990	0.89
Motorola, Incorporated, Government Electronics Group	3,958	0.69
United Engineers and Constructors, Incorporated	3,300	3.44
Loral Corporation		
Loral Command and Control Systems (formerly Ford Aerospace Corporation, Ford Command and Control Systems Group)	3,277	1.33
Loral Electronics Systems	2,052	1.04
Subtotal	5,329	1.20
Beaver Precision Products, Incorporated (formerly Beaver Aerospace, a subsidiary of Dana Corporation)	2,825	33.27
Ball Corporation, Ball Aerospace Systems Group	2,716	2.77
Pneumo-Abex Corporation, Abex NWL, U.S. Operations (formerly Abex Aerospace, U.S. Operations)	2,631	9.51
Atlantic Research Corporation, Aerospace Group (a unit of Sequa Corporation)	2,561	1.76

(continued)

**Appendix II
Contractors Accounting for 89 Percent of All
Defective Pricing Reported by DCAA in Fiscal
Year 1991**

Contractor^a	Defective pricing reported	
	Amount (in thousands of dollars)^b	As a percentage of the value of the contracts DCAA audited at the contractor^c
Science Applications International Corporation, Science Applications International Technology	\$ 2,403	21.23
Israel Aircraft Industries, Limited	2,278	8.18
LTV Aerospace and Defense Company, Missiles Division	2,118	16.54
Parker Hannifin Corporation, Parker Berteau Aerospace, United Aircraft Products Division	2,111	21.26
The Cincinnati Gear Company	2,030	11.92
Mason and Hangar-Silas Mason Company, Incorporated, Iowa Army Ammunition Plant	2,006	2.34
Fansteel, Incorporated, Fansteel Precision Sheet Metal Division	1,890	10.75
Scientific Atlanta, Incorporated, Signal Processing Systems Division	1,696	1.85
Total	\$653,460	2.28

^aConsistent with DCAA's practice, each company unit is listed as a separate contractor.

^bThese amounts represent the total contract price adjustments recommended by DCAA as of the end of the fiscal year. The amount of these recommended price adjustments may change subsequent to the end of the fiscal year due to follow-up audits and additional fact finding.

^cThese percentages represent the ratios of recommended contract price adjustments to the total dollar value of the contracts audited at each contractor.

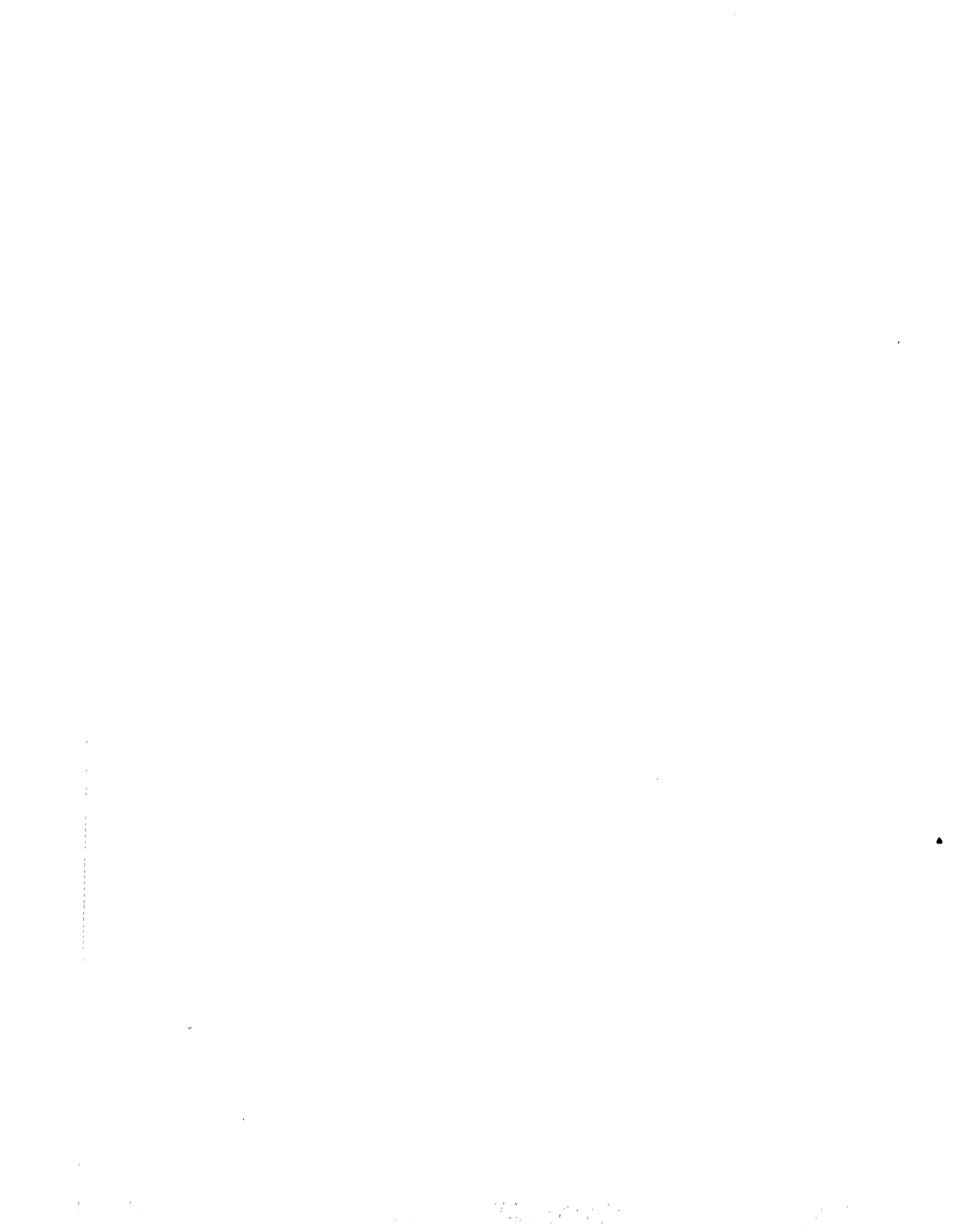
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