

GAO

Testimony

Before the Legislation and National Security Subcommittee,
Committee on Government Operations, House of
Representatives

For Release
On Delivery
Expected at
9:30 a.m. EDT
Wednesday
May 6, 1992

CONTRACT PRICING

**Recurring Issues and the Role
of the Defense Contract Audit
Agency**

Statement of Paul F. Math, Director, Research, Development,
Acquisition, and Procurement Issues, National Security and
International Affairs Division



Mr. Chairman and Members of the Subcommittee:

It is a pleasure to appear before you today to discuss the results of our reviews on Department of Defense (DOD) contracting and on other matters related to the operations and management of the Defense Contract Audit Agency (DCAA).

In 1984, this Subcommittee requested that we expand our audit work examining how well DOD was managing and overseeing the contract pricing process. Since then, we have issued several reports and testified several times before this Subcommittee and other Committees on the results of our reviews. (See a list of related GAO products at the end of this statement.)

More recently, our reviews on DOD contract management, particularly our focus on subcontract management, have supported our initiatives to address the "high-risk" areas in the government, which we reported to you and the Chairman of the Senate Governmental Affairs Committee in January 1990.

As you requested, my testimony today will discuss the systemic contract management issues that we have identified in recent years and the role that DCAA plays in these issues. In addition, I will address the more specific questions you have asked about the operations and management of DCAA. My comments on DCAA are based primarily on issues identified during our audits of DOD contract management. As you requested, we have also prepared a report that summarizes our recent reports on DOD contract and subcontract pricing issues and matters related to DCAA. This report is being issued to you today.

SUMMARY OF RESULTS

Despite the existence of laws and regulations designed to protect the government, overpricing of defense contracts is both significant and widespread. The risks are high and the overpricing amounts to billions of dollars. The government is at risk for overpricing in prime contracts, and it is particularly at risk for overpricing in subcontracts, where DOD relies heavily on the prime contractor and the quality of its cost-estimating system to assure reasonable subcontract prices and where the DOD's awareness of what goes on is limited.

DCAA plays a vital role in protecting the government's interests against overpriced contracts. However, DCAA (1) has limited coverage of contracts and subcontracts subject to audit, (2) is unaware of many other subcontracts subject to audit, (3) does not perform a sufficient number of operations audits, (4) has weaknesses in its estimating systems reports, and (5) has a high backlog of incurred cost audits.

Now is not the time to include DCAA in the Defense Business Operations Fund. While we support the overall objective and concept underlying the Fund, DOD has made only limited progress in developing and implementing key policies and systems for the sound operations of the Fund.

CONTRACT OVERPRICING IS SIGNIFICANT AND WIDESPREAD

Contract overpricing results from two principal factors: (1) when contractors do not provide accurate, complete, and current cost or pricing data, as required by the Truth in Negotiations Act and (2) when contractor cost-estimating systems do not produce reliable contract pricing estimates.

Overpricing Due to Violations of the Truth in Negotiations Act

A principal concern in noncompetitive procurements has been the limited cost or pricing information supporting contractors' proposals that is available to the government at the time of negotiations. Recognizing the government's vulnerability when it does not have accurate, complete, and current cost or pricing data on noncompetitive contracts, the Congress passed the Truth in Negotiations Act in 1962. The act is intended to protect the government against inflated contract estimates by requiring contractors and subcontractors to submit cost or pricing data supporting their proposed prices above certain dollar thresholds and to certify that the data submitted is accurate, complete, and current. Defective pricing occurs when a contract price is increased because the contractor does not provide accurate, complete, and current cost or pricing data, as required by the act. If defective pricing is found, the government can reduce the contract price.

In fiscal years 1987 through 1991, DCAA reported \$3.7 billion in defective pricing. Roughly, one of every three contracts DCAA audited over this period was reported as defectively priced.

A significant portion of the \$3.7 billion in defective pricing identified by DCAA is related to subcontracts. While subcontracts accounted for only 16 percent of the total dollars DCAA examined in fiscal years 1987-1991, subcontract defective pricing accounted for 37 percent of the total defective pricing found by DCAA during that period.

Overpricing Due to Poor Cost-Estimating Systems

In addition to defectively priced contracts, our reviews have shown that defense contractors receive million of dollars in "windfall" profits from overpriced subcontracts.

In the past several decades, as the role of many prime contractors has changed from fabricating weapons and products to integrating work done by subcontractors, subcontract costs have become substantial, and, in many cases, the largest part of a contract's cost. Active DOD subcontracts are estimated at \$193 billion at the end of fiscal year 1990. Because subcontracts are so significant, the estimates of subcontract prices included in prime contractor proposals to the government are a critical element in establishing the reasonableness of the total contract price.

Subcontracting shifts much of the direct management and oversight of subcontract costs from the government to prime contractors. DOD does not have direct management responsibility over subcontracts because it does not have a contractual relationship with the subcontractors. Instead, it relies greatly on prime contractors to ensure that subcontract prices are fair and reasonable.

The existence of sound contractor cost-estimating systems is a major internal control mechanism for ensuring fair and reasonable subcontract prices. In March 1988, in response to our reports and other audit reports showing evidence of significant overpricing, DOD revised its regulations to require major contractors to establish, maintain, and disclose adequate cost-estimating systems. DOD regulations also require contractors to evaluate cost or pricing data supporting certain noncompetitive subcontract prices and include the results of the evaluations as part of their contract proposals. Such evaluations should be made before DOD and the prime contractor agree to a contract price because the evaluations can assist the contracting officers in assuring that only fair and reasonable subcontract estimates are priced into contracts.

Despite DOD's efforts to strengthen its regulations on cost-estimating systems and increase emphasis on subcontract pricing, DOD contracts continue to be overstated by millions of dollars because of inflated subcontract estimates. Contract overpricing is occurring because many prime contractors are not adequately reviewing their subcontract proposals and providing that information to DOD contracting officials before completing negotiations with the government. Too often, the real "scrubbing" of subcontract proposals by the prime contractor takes place after the contractor negotiates with the government. At that point, the prime contractor is frequently able to significantly reduce the subcontract price. When poor cost estimating causes contract overpricing, the government may not have a safeguard, such as the Truth in Negotiations Act, for reducing the inflated contract prices.

Let me give you an example of what I mean by subcontract overpricing. Our audit work, as well as that of the DOD Inspector General, has shown that prime contractors negotiated lower prices with their subcontractors after negotiating higher prices with the

government. This occurred on noncompetitive subcontracts as well as on subcontracts where the prime contractor said the prices were competitively priced. For example, we found that on 12 noncompetitive subcontracts, each in excess of \$1 million, prime contractors awarded these subcontracts for about \$9 million less than the prices negotiated in the contract with DOD. Similarly, we found that on 13 competitively obtained subcontracts, the prime contractor negotiated prices that were about \$3 million less than the amounts negotiated in DOD contracts. The report we issued to you today discusses additional examples of subcontract overpricing.

DCAA'S ROLE IS VITAL IN ASSURING REASONABLE CONTRACT PRICES

DCAA was established in 1965 by consolidating the existing audit organizations of the military services. DCAA performs contract auditing for DOD and provides accounting and financial advisory services to all DOD procurement and contract administration officers. Among its responsibilities, it performs forward pricing audits to evaluate contract proposals for reasonableness, and it audits prime contracts and subcontracts for defective pricing. It also reviews contractor cost-estimating systems for compliance with regulations and, through its operations audits, it evaluates the efficiency of contractor operations. Finally, through its audits of incurred costs, it examines contract costs for allowability, allocability, and reasonableness. In fiscal year 1991, DCAA completed 22,000 forward pricing audits, including 1,150 estimating system surveys; over 30,000 incurred cost audits, including almost 400 operations audits; and about 3,500 defective pricing audits.

Although these are impressive statistics, there are areas where we believe DCAA can increase the protection of government interests.

DCAA's Coverage of Contracts and Subcontracts Is Limited

Because of the large number of contracts and subcontracts that are subject to DCAA audit for defective pricing and the competing demands on its resources, DCAA cannot audit all contracts and subcontracts subject to the Truth in Negotiations Act. As a result, DCAA allocates its resources based on its assessment of risk.

Last year, we testified that, even for those contracts that DCAA considers to be high risk for defective pricing, its audit selection criteria called for it to audit all fixed-price contracts

of \$10 million or more, 1 in 10 contracts between \$1 million and \$10 million, and 1 in 50 contracts between \$100,000¹ and \$1 million. We also found that while DCAA allocated all the resources needed to audit high-risk contracts over \$10 million, because of resource constraints, it was able to allocate only 61 percent of the resources for audits of high-risk contracts under \$10 million. DCAA's audits of lower-risk contracts are even less frequent.

DCAA modified its risk assessment procedures for fiscal year 1992 and intends to give increased attention to contracts under \$10 million. However, its resources still limit the number of contracts it can audit for defective pricing, and a substantial percentage of contracts, especially those of lower dollar value and those of less than high risk, still will not get audited. For example, for high-risk, fixed-price contracts under \$10 million, DCAA's selection criteria calls for it to audit 1 in 15 contracts. For medium-high risk, fixed-price contract, its selection plan calls for it to audit 1 in 30 contracts under \$10 million. In the past, DCAA has not been able to accomplish all the audits that its plans call for.

Given the risks of contract overpricing and the poor state of many contractors cost-estimating systems, contract audit coverage may still not be adequate, even if DCAA is able to obtain some increase in coverage. In a recent review, we found that defective pricing, as a percentage of subcontract value, was highest in smaller subcontracts--those which have the least chance of being selected for audit. For example, we found that defective pricing was on average 11.8 percent of the total value of defectively priced subcontracts under \$10 million. By comparison, defective pricing in subcontracts valued at \$100 million or more averaged 1.5 percent of the total value of defectively priced subcontracts.

Furthermore, defectively priced subcontracts under \$10 million increased as the size of the subcontract decreased. For example, between \$5 million and \$10 million, the rate of defective pricing was 10.2 percent; between \$1 million and \$5 million, it was 13.1 percent; between \$500,000 and \$1 million, it was 17.9 percent; and for subcontracts \$500,000 and under, it was 25.1 percent.²

¹The fiscal year 1991 National Defense Authorization Act (P.L. 101-510) has since raised the dollar threshold for contracts that require the submission of cost or pricing data to \$500,000.

²Statistics for subcontracts \$500,000 and under reflect the period of time when the threshold for cost or pricing data was \$100,000.

DCAA Is Unaware of Many Subcontracts Subject to Audit

Because subcontracting is so significant, it is crucial that DCAA be in a position to assess subcontract risk and appropriately allocate its resources to audits of subcontract defective pricing. This requires that DCAA be aware of the universe of subcontracts subject to audit for defective pricing under the Truth in Negotiations Act.

In the past year, we analyzed 211 subcontracts that were contained in 4 major DOD prime contracts--2 from the Air Force, and 1 each from the Army and Navy--to determine the extent to which DCAA was aware of these subcontracts. Collectively, these subcontracts had a dollar value of about \$337 million and represented subcontractors located in 54 of DCAA's 152 field offices. We found that DCAA was not aware of 186, or 88 percent, of the 211 subcontracts we reviewed. Each of these subcontracts met the threshold requirement for cost or pricing data and, therefore, was subject to a DCAA defective pricing audit.

There are two primary reasons why DCAA is unaware of subcontracts. First, the data sources DCAA currently use to develop its subcontract inventory is incomplete. Second, when DCAA field offices become aware of subcontracts during their audits of prime contracts, they do not routinely pass this information to the field offices responsible for the subcontracts.

Being unaware of so many subcontracts increases the government's vulnerability to undetected subcontract defective pricing. It also understates the number of audits, and staff resources, necessary to reduce the risk of defectively priced contracts.

More Operations Audits Can Reduce Contract Costs

Operations audits are another area where we see increased government risk as a result of limited DCAA emphasis. Operations audits are designed, in part, to evaluate the economy and efficiency of a specific contractor function or operation. These reviews can and have resulted in recommendations to eliminate unnecessary costs or waste, which, in turn, reduce DOD contract costs.

In our October 1991 report, we stated that although operations audits have had substantial payback, DCAA has decreased the number of operations audits it performs. We recommended that DCAA increase the priority it gives to operations audits.

While DOD agreed that operations audits have successfully identified ineffective or uneconomical contractor practices and have reduced costs for both contractors and DOD, it indicated that resource limitations restrict DCAA's ability to perform additional operations audits.

We still believe that DCAA should perform more operations audits. As the downsizing of defense continues, some contractors will be hard pressed to maintain an efficient level of operations, and we may well see contractor overhead rates creeping upward and operational inefficiencies increase. In fact, we already have indications that contractor overhead rates are rising. We found that overhead rates at many major DOD contractors have increased since 1987 as the value of their DOD contracts declined. Our analysis of selected contractor overhead rates showed that while overhead rates generally increased between 1987 and 1989, the increase was much greater as sales declined. Higher overhead rates increase contract costs. This makes it even more imperative that DCAA devote sufficient resources to examining the efficiency of contractor operations, especially those operations that affect overhead costs.

DCAA's Estimating Reports Can Be Improved

Where estimating deficiencies are identified by DCAA, they need to be clearly communicated to the contractor and to the contracting officer, and they must be resolved quickly. We have seen millions of dollars lost because of poor contractor estimating systems or untimely correction of identified estimating deficiencies.

In a recent review, we found that DCAA reports, which identified subcontract estimating deficiencies, did not always adequately demonstrate and emphasize to administrative contracting officers and contractors the need to correct these deficiencies. Many DCAA reports did not illustrate the potential cost impact of the identified deficiencies or contain appropriate recommendations for disapproving inadequate systems. Both of these actions are required by DCAA's reporting procedures.

We recommended that DCAA emphasize to its field audit offices the importance of providing examples of cost impact to demonstrate the significance of the estimating system deficiencies it found. We also recommended that DCAA monitor estimating system survey and follow-up reports until improvements are noted in field audit offices' reports. DCAA has issued guidance to address these recommendations. We have not yet followed up to see how well the guidance is being implemented. Effective implementation at the field level is the key to resolving these problems.

DCAA's Incurred Cost Backlog Is High

According to DCAA data, its backlog of incurred cost audits was about \$150 billion at the end of fiscal year 1991. This amount is a decrease from its recent peak of \$170 billion at the end of fiscal year 1989.

There are several reasons to be concerned about the high incurred cost backlog. For several years, DCAA has reported that deferring audits of incurred costs increases the risks to the government of overpriced contracts. This happens because contractors may use unaudited historical costs containing unallowable costs to negotiate contracts with the government. For example, we found at one contractor location we visited that because of delays in auditing incurred costs, at least \$800,000 that DCAA subsequently identified as unallowable costs were included in the contractor's proposed overhead rates and used to price DOD contracts.

According to DCAA's latest projection, which was provided to us in April, its future staffing levels will allow it to reduce the incurred cost audit backlog to \$68 billion, or about one year's work by the end of fiscal year 1997. This projection of reduced backlog is significantly different from two other recent projections that DCAA provided us. In October 1991, DCAA estimated that its incurred cost backlog would increase rapidly in the future, reaching \$241 billion by the end of fiscal year 1997. In January 1992, DCAA projected that the backlog would decrease to \$116 billion by the end of fiscal year 1997.

DCAA is once again revising its incurred cost backlog projections using more recent DOD estimates of future DCAA staffing, defense spending, inflation, and other factors. Changes in these estimates, particularly those relating to staffing and defense spending, could have a material effect on DCAA's projections of incurred cost backlog.

Status of the Defense Business Operations Fund

In October 1991, DOD implemented the Defense Business Operations Fund, which consolidated the nine existing industrial and stock funds operated by the military services and DOD, as well as other activities. Under the Fund, goods and services are offered, on a reimbursable basis, to activities within DOD, as well as to non-DOD activities, when authorized.

Last year, in a testimony before the Subcommittee on Readiness, House Armed Services Committee, we supported the concept underlying DOD's initiative to establish the Defense Business Operations Fund, but we had reservations about DOD's ability to successfully implement its plans for the Fund in fiscal year 1992. In considering DOD's fiscal year 1992 budget, the Congress also had concerns about the establishment and operation of the Fund.

Because of these concerns, the National Defense Authorization Act for Fiscal Years 1992 and 1993 directed that no new activities be added to the Fund prior to April 15, 1993, so that the Congress could evaluate the Fund's performance before any further expansion. DOD initially planned to include DCAA as a support activity in the Fund in fiscal year 1993. However, as a result of the legislation, DCAA will be not be included in the Fund in fiscal year 1993. However, we understand that DOD plans to include DCAA in the Fund in fiscal year 1994.

On April 30, 1992, we again testified before the Subcommittee on Readiness, House Armed Services Committee on the implementation status of the Fund. While we continue to support the overall objective and concept underlying the Fund, our review has shown that DOD has made only limited progress in developing and implementing key policies and systems for the sound operation of the Fund. As a result, we believe that DOD should not be permitted to add any new activities in fiscal year 1994. This would include DCAA. Further, until the benefits of the Fund are convincingly demonstrated, we believe that the Congress should refrain from permanently authorizing the Fund.

One of our concerns with respect to the inclusion of DCAA into the Fund is how DCAA's important discretionary work, such as its defective pricing audits will be supported, and whether DCAA's ability to perform independent contract audits might be affected. In the final analysis, whether and how DCAA's work may be affected will depend on how DOD plans to include DCAA in the Fund and how it plans to fund DCAA. We have not seen those plans. When DOD completes those plans, we would be more than willing to review and comment on them.

OBSERVATIONS

Contract overpricing remains a high-risk area, vulnerable to fraud, waste, and mismanagement. As a result, DCAA must have sufficient audit resources and adequate information to assure that the government's interests are adequately protected. We believe the contract overpricing risks to the government can be reduced if DCAA:

- performs more defective pricing reviews of contracts and subcontracts subject to the Truth in Negotiations Act,
- increases its awareness of subcontracts subject to defective pricing audits and assesses the risks associated with these subcontracts,
- increases the number of operations audits it performs annually,
- improves its estimating systems reports so that they demonstrate the significance of the identified deficiencies, and

-- reduces its backlog of incurred cost audits.

Most of the above actions would require additional resources. Because of the continuing high risk in contract pricing and the need for adequate audit coverage, we believe that DCAA's staff reductions should be limited so as to allow it to increase its coverage of these high-risk areas. The extent to which reductions should be limited depends, in part, on the degree to which reduced resources needed to perform forward pricing proposal audits can be reallocated to these high-risk areas.

Mr. Chairman, this concludes my statement. I will be pleased to answer any questions you or the members of the Subcommittee may have at this time.

RELATED GAO PRODUCTS

Defense Business Operations Fund Implementation Status
(GAO/T-AFMD-92-8, Apr. 30, 1992).

Contract Pricing: Economy and Efficiency Audits Can Help Reduce Overhead Costs (GAO/NSIAD-92-16, Oct. 30, 1991).

Contract Pricing: Defense Contract Audit Agency's Estimating Reports Can Be Improved (GAO/NSIAD-91-241, Aug. 1, 1991).

Defense's Planned Implementation of the \$77 Billion Defense Business Operations Fund (GAO/T-AFMD-91-5, Apr. 30, 1991).

Contract Pricing: Inadequate Subcontract Evaluations Often Lead to Higher Governmental Costs (GAO/NSIAD-91-161, Apr. 5, 1991).

Contract Pricing: Defense Subcontract Cost-Estimating Problems Are Chronic and Widespread (GAO/NSIAD-91-157, Mar. 28, 1991).

Contract Pricing: Competitive Subcontract Price Estimates Often Overstated (GAO/NSIAD-91-149, Mar. 20, 1991).

Contract Pricing: Subcontractor Defective Pricing Audits
(GAO/NSIAD-91-148FS, Mar. 21, 1991).

Contract Pricing: Status of DOD Defective Pricing .
(GAO/NSIAD-91-33FS, Jan. 15, 1991).

Correspondence Transmitting GAO List of High-Risk Areas
(Jan. 23, 1990).

(396699)