

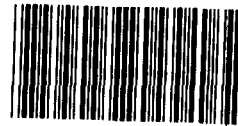
GAO

Report to the Chairman, Subcommittee on  
Research and Development, Committee on  
Armed Services, House of Representatives

September 1992

# GOVERNMENT CONTRACTING

## Proposed Regulation Would Limit DOD's Ability to Review IR&D/B&P Program



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**National Security and  
International Affairs Division**

B-207974

September 24, 1992

The Honorable Ronald V. Dellums  
Chairman, Subcommittee on Research  
and Development  
Committee on Armed Services  
House of Representatives

Dear Mr. Chairman:

As you requested, we examined whether the Department of Defense (DOD) will have adequate financial and technical data to assess the impact of legislation that reduced its surveillance of contractors' Independent Research and Development and Bid and Proposal (IR&D/B&P)<sup>1</sup> programs. In addition, we attempted to determine whether the program's administrative costs will be reduced as the legislation intended.

**Results in Brief**

The Defense Contract Audit Agency (DCAA) has informed the Office of the Secretary of Defense that it no longer plans to prepare its annual financial report on IR&D/B&P. The proposed changes to DOD regulations, dated April 1, 1992, assigning responsibility for preparing an annual report, are vague on the specific type of financial data needed to exercise reasonable control to ensure that IR&D/B&P expenditures remain within affordable levels. Without statistical data previously provided in DCAA's annual reports on IR&D/B&P, DOD will not have reasonable assurances that the program is being implemented as intended, objectives are being met, policies are being followed, and resources are being effectively used.

Administrative costs are not likely to be significantly reduced as intended by recent legislation for two reasons: (1) the government will still be required to determine the reasonableness of IR&D/B&P costs and (2) contractors are still expected to provide the government with technical information to monitor the defense technology base. DOD has already streamlined the data to be provided and is attempting to eliminate the multiple technical data bases.

<sup>1</sup>IR&D is research and development not specified under any contract or grant, and B&P costs are incurred in preparing, submitting, and supporting contract bids and proposals. These costs are reimbursed as a portion of the negotiated overhead.

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## Background

For many years, DOD has fostered contractors' IR&D/B&P programs as an integral part of the defense technology base. To put some limit on DOD's reimbursements for IR&D/B&P, Public Law 91-441 was enacted in 1970. This law required DOD to place ceilings on the amount of IR&D/B&P costs that contractors could include in overhead. This process generally consisted of (1) the government performing an on-site technical evaluation of a contractor's IR&D program, (2) the contractor and the government negotiating a cost ceiling on IR&D/B&P based, in part, on the results of the technical review, and (3) contractors recovering negotiated IR&D/B&P costs in overhead. Where DOD contracts make up a majority of the contractor's business, DOD reimburses contractors for a majority of this overhead expense.

In the process of limiting IR&D/B&P costs by negotiated ceilings, extensive technical reviews of contractors' IR&D/B&P programs were established. Contractors prepared elaborate brochures and on-site reviews of contractors' programs were standard.

Public Law 91-441 also required DOD to submit annually to Congress a report of statistics on the IR&D/B&P costs allocated to defense contracts. The reports contained the (1) total IR&D/B&P costs incurred at the major contractors with negotiated ceilings, (2) costs that were allowable to be charged into overhead (i.e., the ceiling), and (3) share of the allowable costs that would be reimbursed against DOD contracts.

The National Defense Authorization Act for Fiscal Years 1992 and 1993 (P.L. 102-190), however, contains provisions that will, over a 3-year period, gradually remove the limitations on the amount DOD will reimburse contractors in their overhead for IR&D/B&P expenditures. The intent of these provisions is to increase industry's overall expenditures for IR&D during the expected decline in the overall defense budget. The act also required DOD to eliminate any unnecessary government technical reviews of contractors' IR&D programs. Eliminating the ceilings and unnecessary technical reviews were intended to reduce administrative expenditures. However, the act was silent on the subject of DOD furnishing statistical data on IR&D/B&P.

Various estimates have been made on the budgetary impact of removing the IR&D/B&P ceilings. For example, a defense industrial association estimated that removing the ceilings would only increase costs to the government by approximately \$100 million. DOD, on the other hand,

estimated that by 1996 the added cost would be approximately \$1 billion annually.

DOD in expressing its views on this legislation stated that "it is essential that the Secretary of Defense have the authority to exercise reasonable control to ensure that additional [IR&D/B&P] expenditures remain within affordable levels."

On April 1, 1992, DOD issued its proposed changes to the regulations needed to implement the act. These proposed regulations provide in a general way for (1) an annual report on the DOD-wide IR&D/B&P program and (2) contractors to provide DOD with brief technical descriptions of their IR&D/B&P projects.

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## Statistical Data Available Through DCAA Is Necessary to Adequately Manage IR&D/B&P Program

Although the proposed regulations needed to implement the National Defense Authorization Act contain a general requirement for annual reporting on the IR&D/B&P program, they are vague as to the specific types of statistical information that should be reported. The DCAA annual report, required under the Public Law 91-441, included such data as (1) number of companies with negotiated ceilings, (2) total IR&D/B&P expenditures by those companies, (3) the amount of costs allowed to be charged into overhead, and (4) the amount of costs that will be reimbursed against DOD contracts.

The data required to fulfill the requirements of the statistical report required formerly by Public Law 91-441 are available from the books and accounts of contractors. DCAA is the agency that has responsibility for auditing those accounts, and is therefore the government's principal access point for such data.

Without the DCAA annual report, statistical data will not be available for DOD managers to (1) monitor the ceilings during the 3-year transitional period, (2) assess the budgetary impact of removing the ceilings, (3) identify whether full recovery of IR&D/B&P expenditures will increase industry's overall expenditures for IR&D, and (4) determine whether contractor's IR&D expenditures change in relation to their B&P expenditures.

Considerable debate has taken place on the question of whether allowing contractors full recovery of their expenditures for IR&D will increase overall expenditures for that technical effort. For example, a RAND Corporation

study concluded that as government support increases, industry would increase the IR&D efforts.<sup>2</sup> On the other hand, DOD officials foresee no substantial change in contractor's overall expenditures on IR&D. Representing still another view, representatives of industry and a defense industrial association told us they do not believe removing the ceiling will result in increased IR&D expenditures and because of general economic constraints, contractor expenditures on IR&D may actually decrease.

Nevertheless, detailed financial data of the type included in the previous DCAA reports would show whether providing full recovery to all contractors for their IR&D expenditures produced the desired end of increasing industry's overall expenditures for IR&D.

There is also concern as to whether contractors will shift expenditures from IR&D to B&P. DOD officials told us that, in a time of predicted declining defense budgets, companies may increase their B&P rather than their IR&D expenditures. This is because B&P expenditures that are incurred in preparing, submitting, and supporting bids and proposals on potential contracts, are more likely to provide a better return for the company in the near term. IR&D expenditures tend to result in technology development for longer term future business.

Spending additional funds on B&P at the expense of IR&D may not advance the legislative intent of furthering independent development of advanced technology. However, without a report including the type of information previously prepared by DCAA, DOD will not be in a position to track the expenditures that industry as a whole is making on IR&D in relation to B&P.

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## Administrative Costs Will Not Be Significantly Reduced

Administrative costs are not likely to be significantly reduced as intended by the recent legislation for two reasons: (1) even though ceiling negotiations will no longer be required, the government will still be required to determine the reasonableness of IR&D/B&P costs and (2) contractors are still expected to provide the government with technical information to monitor the defense industrial base.

Ceilings negotiated between DOD and each contractor will no longer be required effective October 1, 1992. However, proposed regulations would

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<sup>2</sup>The Defense Department's Support of Industry's Independent Research and Development (IR&D): Analysis and Evaluation, The RAND Corporation, April 1989.

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require that the government contracting officer still determine whether the IR&D/B&P costs are reasonable in terms of both the content and amount of the IR&D/B&P costs. Therefore, there will be administrative costs associated with determining the reasonableness of contractors' IR&D/B&P costs, which will reduce the estimated savings of eliminating the administrative costs of negotiating annual ceilings.

In addition, DOD officials claim that the major portion of administrative costs have been associated with the technical review of contractors' IR&D programs. Provisions of the recent legislation strongly encourage the establishment of a simplified communication mechanism for the exchange of IR&D technical information between DOD and major contractors. DOD technical representatives do not believe that a significant reduction in the technical data over and above what they have already accomplished is warranted, and therefore additional reductions in administrative costs associated with preparing the technical descriptions of their IR&D projects are not likely to occur.

Having technical data on industry's IR&D efforts is necessary for DOD to properly plan its total Science and Technology Program. DOD uses technical data from contractors to develop their overall technology plan. IR&D forms an important segment of the overall defense industry's expenditures in technology development. For example, DOD funds technologies directly through the Science and Technology Program and indirectly through the IR&D/B&P costs.<sup>3</sup>

Prior to the recent legislation, DOD had made major strides in reducing the technical data required from contractors, thereby reducing administrative costs. For example, DOD had limited the project descriptions that contractors were required to submit to a maximum of 5 pages, including graphics, whereas in the past the project descriptions have exceeded 30 pages. Limiting the project descriptions to five pages reduced the administrative burden on large defense contractors who often have hundreds of IR&D projects.

Over the years, the Office of the Secretary of Defense has maintained a data base to reflect information on contractors' IR&D projects. However,

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<sup>3</sup>Under the Science and Technology Program, military services and defense agencies finance through contract or grants, research by universities, contractors, and government laboratories. In fiscal year 1991, DOD received \$8.5 billion for the Science and Technology Program. In addition, in fiscal year 1990, contractors spent \$7.3 billion on IR&D/B&P. This illustrates the importance of the IR&D/B&P to the overall technology development efforts.

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the military services did not consider this data base sufficient or timely to meet their needs. As a result, the Air Force and Army have created their own data base to reflect information contained in contractors' technical plans. DOD is attempting to eliminate these multiple data bases.

As currently envisioned, DOD's new data base will require contractors to submit technical descriptions of their IR&D projects on magnetic tape or floppy discs with one hard copy backup. This process is expected to reduce the number of copies that contractors will be required to distribute to government officials. DOD would provide this computerized data to the services, laboratories, and other research and development personnel.

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## Recommendations

We recommend that the Secretary of Defense

- direct DCAA to resume preparing the annual financial report on contractor IR&D/B&P expenditures and reimbursements and
- ensure that duplicate technical data bases are eliminated.

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## Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD agreed with our findings and recommendations. DOD's comments are reprinted in their entirety in appendix I.

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## Scope and Methodology

To obtain the information for this report, we interviewed officials and reviewed documents at the Office of the Secretary of Defense, DCAA, Defense Logistics Agency, and the Departments of the Air Force, Army, and Navy.

We met with individuals from industry and the government who negotiated ceilings and participated in technical reviews. We also discussed the legislation with an industry association and a selected group of DOD contractors.

We conducted our review between June 1991 and April 1992 in accordance with generally accepted auditing standards.



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We are sending copies of this report to the Secretary of Defense; other interested congressional committees; and the Director, Office of Management and Budget. We will make copies 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 II.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Paul F. Math". The signature is stylized with a large, sweeping initial "P" and a cursive "M".

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

# Comments From the Department of Defense



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100


SEP 2 1992

Mr. Frank C. Conahan  
Assistant Comptroller General  
National Security and International  
Affairs Division  
U.S. General Accounting Office  
Washington, DC 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "GOVERNMENT CONTRACTING: Proposed Regulations Would Limit DoD's Ability to Review IR&D/B&P Program," dated July 11, 1992 (GAO Code 396150/OSD Case 9138). The Department concurs with all of the findings and recommendations.

Detailed DoD comments on the two recommendations are provided in the enclosure. The Department appreciates the opportunity to comment on the draft report.

  
Alvin Tucker  
Deputy Comptroller  
(Management Systems)

Enclosure

GAO DRAFT REPORT--DATED JULY 13, 1992  
(GAO CODE 396150) OSD CASE 9138

"GOVERNMENT CONTRACTING: PROPOSED REGULATIONS WOULD  
LIMIT DOD'S ABILITY TO REVIEW INDEPENDENT RESEARCH AND  
DEVELOPMENT/BID AND PROPOSAL PROGRAM"

DEPARTMENT OF DEFENSE COMMENTS

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RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Defense Contract Audit Agency to resume preparing the annual financial report on contractor independent research and development/bid and proposals expenditures and reimbursements. (p. 9/GAO Draft Report)

Now on p. 6.

DOD RESPONSE: Concur. The Department agrees that the cost impact of Public Law 102-190, Section 802, Full Recovery Provisions, must be measured at the larger contractors. Such information will be needed (1) for proper application of the transition period limitations to be included in the Federal Acquisition Regulation 31.205-18(a), and (2) for determination as to whether additional controls on independent research and development and bid and proposal expenditures will be recommended in the future. Further, the Department agrees the Defense Contract Audit Agency is the organization that can most efficiently accumulate the required data. As recommended, the Defense Contract Audit Agency will be instructed to resume preparation of an annual statistical report. The first report, covering FY 1992, will be submitted on or before March 15, 1993.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Defense Contract Audit Agency to eliminate duplicate technical data bases. (p. 9/GAO Draft Report)

Now on p. 6.

DOD RESPONSE: Concur. In its report, the General Accounting Office acknowledged DoD efforts to eliminate duplicate technical data bases and the continuing effort toward that goal. Contractor technical data is now submitted directly to the Defense Technical Information Center in electronic form. In the near future the information will be routinely converted to a CD-ROM format for timely distribution to the Military Services and other users. The cited actions are intended to eliminate any perceived need for the maintenance of duplicate data bases.

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# Major Contributors to This Report

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