

GAO

Report to the Chairman, Committee on
Governmental Affairs, U.S. Senate

July 1994

CONTRACT PRICING

DOD Management of Contractors With High Risk Cost-Estimating Systems



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

National Security and
International Affairs Division

B-256865

July 19, 1994

The Honorable John Glenn
Chairman, Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

As you requested, we evaluated Department of Defense (DOD) efforts to ensure that high-risk contractors reduce the government's vulnerability to contract overpricing. More specifically, we reviewed (1) the extent to which contractors were correcting the significant cost-estimating system deficiencies¹ identified through Defense Contract Audit Agency (DCAA) audits, (2) the actions DOD contracting officers were taking to encourage contractors to improve their cost-estimating systems, and (3) the adequacy of DOD controls to ensure that deficiencies were corrected in a timely manner. We focused our review on the activities associated with 30 of the DOD contractors DCAA assessed as having high risk cost-estimating systems as of May 1992. According to DCAA, these 30 contractors had a total of 117 significant cost-estimating system deficiencies.²

Results in Brief

Contractors' performance in correcting their significant cost-estimating system deficiencies has been mixed. Although 19 of the 30 contractors had corrected or potentially³ corrected all their significant cost-estimating system deficiencies, the remaining 11 contractors had significant uncorrected deficiencies that have been outstanding an average of 3.8 years. Not correcting estimating deficiencies in a timely manner creates a variety of problems for DOD, including increased costs and delays in contract awards.

DOD contracting officers have used various actions to encourage contractors to correct their cost-estimating system deficiencies. These

¹Defense Federal Acquisition Regulation Supplement (DFARS) section 215.811-70 defines a significant estimating system deficiency as a shortcoming that is likely to consistently result in proposal estimates for total cost or a major cost element that do not provide an acceptable basis for negotiating fair and reasonable prices.

²DCAA conducts an annual assessment of contractors' risk of defective pricing. For its fiscal year 1993 rating, DCAA identified 38 contractors with high risk cost-estimating systems. We did not include eight of these contractors in our sample because three were not DOD contractors, and we found that five contractors had no significant cost-estimating system deficiencies.

³We considered deficiencies to be potentially corrected when a contractor reported that the deficiency was corrected, but the contracting officer had not yet determined the adequacy of the contractor's actions.

included (1) providing contractors with the estimating system audit report and asking that the deficiencies be corrected and (2) forming joint work groups with contractors to help identify problems and develop corrective actions. However, even when significant deficiencies have remained uncorrected for years, contracting officers have not used the more stringent measures available, such as reducing progress payments or recommending nonaward of future contracts.

Our review indicated that even when contractors had long-standing estimating system deficiencies, the Defense Logistics Agency (DLA) had not attempted to (1) determine the reasons for delays in correcting the deficiencies or (2) ensure that contractors and DOD contracting officers were taking all appropriate actions to correct them. Recent DOD Inspector General (DOD/IG) reports also discuss similar problems with DOD's oversight of contractors and contracting officers.

Our review shows that DLA oversight of contracting officers is important—especially where deficiencies are longstanding—for two reasons. First, contracting officers have considerable latitude in deciding how to obtain corrective action. The DOD guidance allows contracting officers to take whatever action they deem necessary to ensure contractors correct deficiencies. Second, DOD does not specify criteria used to determine timeliness of corrective actions. DOD guidance uses 12 months as an indicator of overaged audit reports, but DOD officials told us that because some deficiencies are inherently complex and require more time to correct, they were not alarmed when corrective actions were not taken in the first 12 months. Although contracting officers need flexibility in working with contractors, our review shows that DOD also needs to periodically review the adequacy of contracting officer actions and ensure estimating system deficiencies are corrected in a timely manner.

Background

Contractor estimating systems that produce reliable price proposals are a key safeguard to obtaining fair and reasonable contract prices. Government administrative contracting officers⁴ are responsible for determining the adequacy of the contractors' estimating systems, and, if the estimating systems are deficient, for obtaining correction under DOD regulations. If DCAA reports cost-estimating system deficiencies, DFARS 215.811 requires contractors to formally disagree with the estimating

⁴In this report, we use the term contracting officers when referring to the government's administrative contracting officers. These contracting officers are employed by the Defense Contract Management Command, Defense Logistics Agency.

system report, or within 60 days of being notified of the deficiencies, to correct the deficiencies or to submit corrective action plans. If a contractor has not submitted an adequate corrective action plan or corrected significant deficiencies within 45 days after the contracting officer's evaluation of the contractor's 60-day response, DFARS 215.811 authorizes contracting officers to disapprove the contractor's estimating system, in whole or in part. The notice of disapproval must be sent to each defense contracting and contract administration office having substantial business with the contractor.

After the contractor's corrective action plan has been approved, contracting officers must monitor the contractor's progress in implementing the plan and correcting deficiencies. If the contractor does not make adequate progress in correcting deficiencies, the regulation authorizes the contracting officer to take actions to obtain correction such as reducing or suspending progress payments, recommending nonaward of potential contracts, referring the matter to higher levels of DOD management, or other actions the contracting officer deems appropriate. The DLA field organization manual states that DLA supervises contracting officers through its district and Defense Plant Representative offices and Defense Contract Management Area offices.

Twenty Seven Percent of Deficiencies Remain Uncorrected

As of January 31, 1994, the 30 contractors in our sample had corrected or potentially corrected 85 of the 117 significant cost-estimating system deficiencies (73 percent). However, the 32 remaining deficiencies had been outstanding an average of 3.8 years (see table 1).

Table 1: Age of Uncorrected Cost-Estimating System Deficiencies

| Period (years) | Uncorrected deficiencies | |
|------------------|--------------------------|------------|
| | Number | Percent |
| Less than 1 | 0 | 0 |
| 1 to less than 2 | 2 | 6 |
| 2 to less than 3 | 4 | 13 |
| 3 to less than 4 | 11 | 34 |
| 4 to less than 5 | 10 | 31 |
| 5 or more | 5 | 16 |
| Total | 32 | 100 |

DLA has no specific criteria for evaluating the timeliness of a contractor's corrective actions. According to DOD officials, the acceptable time frame

for corrective action depends upon the complexity of the cost-estimating system deficiency. Some may be easily corrected and require little time, while others may be more difficult and require considerable time to resolve. As a result, DLA allows contracting officers flexibility in determining whether a contractor is correcting a particular deficiency in a timely manner.

Among the 30 contractors sampled, the extent to which significant deficiencies were corrected ranged from contractors that corrected all deficiencies to contractors that corrected none (see table 2).

Table 2: Status of Deficiencies by Contractor

| Status of deficiencies | No. of contractors | No. of deficiencies | | | Total |
|-----------------------------|--------------------|------------------------|------------------------------------|----------------------------|------------|
| | | Corrected ^a | Potentially corrected ^b | Not corrected ^c | |
| All deficiencies corrected | 19 | 52 | 13 | 0 | 65 |
| Some deficiencies corrected | 6 | 18 | 2 | 13 | 33 |
| No deficiencies corrected | 5 | 0 | 0 | 19 | 19 |
| Total | 30 | 70 | 15 | 32 | 117 |

^aWe considered a deficiency to be corrected when a contracting officer approved the contractor's implemented corrective actions.

^bWe considered a deficiency to be potentially corrected when a contractor reported that the deficiency was corrected, but the contracting officer had not yet determined the adequacy of the contractor's actions.

^cWe considered a deficiency to be uncorrected if a contracting officer had determined that the deficiency was not corrected.

Of the 11 contractors with the 32 significant uncorrected cost-estimating system deficiencies shown in table 2,

- 7 contractors with 24 deficiencies had corrective action plans, but the plans had yet to be implemented;
- 1 contractor had corrective action plans for 2 of its 3 uncorrected deficiencies, but not for the 3rd, which is pending the outcome of litigation; and
- 3 had no corrective plans to address their 5 uncorrected deficiencies, and 1 of the 3 contractors had 1 deficiency that is pending the outcome of litigation.

Uncorrected Estimating System Deficiencies Cause DOD Contracting Officers to Take Steps to Protect the Government's Interests

When significant estimating system deficiencies exist, DOD officials must take steps to ensure that they negotiate fair and reasonable contract prices and to protect the government against overpriced contracts. These steps can include using additional cost analysis techniques to determine the reasonableness of the proposed prices, allowing a contractor additional time to correct the deficiency and to submit a corrected proposal, reduce the negotiation objective for profit or fee,⁵ or negotiating a contract clause that allows for adjustment of the contract amount after award.

The extra steps DOD takes are frequently time-consuming and costly. For example, in December 1991, DCAA reported that a certain contractor had five significant estimating system deficiencies. DCAA first reported these deficiencies in September 1990. The deficiencies remained uncorrected when, in June 1992, the contractor submitted a \$550 million proposal to DOD that was based on costs generated by the estimating system.

After a substantial effort, DCAA and Army officials involved in the negotiation said they identified numerous errors in the proposal that would have significantly increased the government's costs. For example, DCAA's audit of the proposal found it to be unacceptable as a basis for negotiating a fair and reasonable price. When the contractor resubmitted data, DCAA found much of it still unacceptable. DCAA officials told us that auditing the contractor's proposal was time-consuming because they were not sure of the quality of the data submitted and needed to verify nearly all the information in the proposal. As a result, DCAA officials said they used more audit resources than normally would have been required.

Army contracting officials said they also invested considerable effort in obtaining and reviewing information from the contractor. The Army's contracting officer said the Army submitted about 100 requests to the contractor for additional information, more than twice the normal number of requests. Army contracting officials said that because they did not trust the contractor's estimating system, reviewing the data the contractor provided was time-consuming.

⁵Federal Acquisition Regulation (FAR) section 15.807 requires contracting officers to establish prenegotiation objectives, including a profit or fee objective, before negotiating a contract. DFARS 215.9 requires that contracting officers set a profit or fee objective based, among other things, on the contract's technical uncertainties, the degree of management effort necessary, and the contractor's efforts to control costs. Contracting officers can reduce profit or fee objectives if a contractor has a marginal cost-estimating system or if it submitted an inadequate cost proposal.

Contracting Officers Did Not Use Their Strongest Regulatory Sanctions

Although some contractors' significant deficiencies have been outstanding for years, contracting officers have been reluctant to use the strong sanctions provided by the FAR. The contracting officers responsible for the contractors with significant uncorrected cost-estimating system deficiencies used a variety of approaches to get corrective action in addition to providing the contractors with DCAA's estimating system audit report and requesting that the deficiencies be corrected (see table 3). However, no contracting officers took the more stringent measures allowed under regulations—reducing or suspending progress payments or recommending nonaward of potential contracts. The contracting officers believed using the more stringent measures was not necessary because, in their opinion, the contractors were making adequate progress or because it would affect the award of future contracts.

Table 3: Contracting Officers' Actions for 11 Contractors With Uncorrected Deficiencies

| Actions taken to resolve deficiencies (from least to most severe) | No. of contractors |
|--|---------------------------|
| Provided contractor with estimating system audit report and asked that deficiencies be corrected | 11 |
| Joined work groups with contractor to help focus the contractor's needed corrections | 5 |
| Notified the contractor of intent to disapprove estimating system in whole or in part | 4 |
| Disapproved estimating system in whole or in part | 3 |
| Lowered threshold for requiring cost or pricing data ^a | 1 |
| Brought issue to higher DOD management attention | 1 |
| Reduced or suspended progress payment | 0 |
| Recommended nonaward of potential contracts | 0 |

^aThe Truth in Negotiations Act (P.L. 87-653, codified at 10 U.S.C. 2306a) is intended to protect against inflated contract prices by requiring contractors to submit cost or pricing data and to certify that the data submitted are accurate, complete, and current. The act requires certification on contracts of \$500,000 or more. In this case, according to the contracting officer, he encouraged the contractor to improve its estimating system by requiring cost or pricing data on contracts of less than \$500,000, thus requiring certified cost or pricing data on more contract modifications. The contracting officer planned to eliminate this requirement when the contractor had corrected its significant estimating system deficiencies.

To obtain a clearer understanding of contracting officers' actions in cases where significant deficiencies remained uncorrected for long periods, we reviewed three contractors in detail. These contractors had uncorrected deficiencies that were outstanding for 3 to almost 5 years. The three cases show that progress in correcting deficiencies has been slow and that contracting officers are not using the more severe types of sanctions available to resolve the estimating deficiencies.

In September 1989, one contractor was reported by DCAA to have three significant cost-estimating system deficiencies: (1) not considering historically negotiated price reductions when estimating subcontract prices, (2) not providing adequate cost or pricing data to support estimated computer costs transferred from another division, and (3) not having adequate procedures to ensure that contractor estimators used appropriate cost or pricing data for estimating material and subcontract costs. In October 1989, the contractor submitted its corrective action plan that showed the deficiencies would be corrected by February 1990. However, the contractor did not resolve these deficiencies. A joint government/contractor team, established by the contracting officer in February 1991, was also unsuccessful in resolving the deficiencies. In July 1992, the contracting officer notified the contractor of the government's intent to disapprove the contractor's estimating system. According to the contracting officer, he did not, however, disapprove the system because (1) the contractor was the sole source of the items under contract and the government could not award the contract to anyone else and (2) one deficiency was in litigation. As of January 31, 1994, more than 4 years after the deficiencies were first reported, the three deficiencies remained uncorrected (one of the three deficiencies was in litigation).

For another contractor, DCAA reported four significant deficiencies between April 1988 and January 1991. These deficiencies were (1) proposing direct labor costs based on information relating to labor-skill mix that could have caused a material difference between the amounts proposed and the amounts charged to the contract; (2) estimating material costs using obsolete information and without providing proper support; (3) performing inadequate cost analyses and not providing appropriate use of comparative analyses for single-source subcontracts; and (4) using an unacceptable overhead allocation factor to propose engineering and manufacturing contract labor, which could result in overstated labor costs. The contracting officer told us the contractor's corrective action plan was informally approved. As of January 31, 1994, three of the four deficiencies remained uncorrected and had been outstanding an average of 3.5 years. The contracting officer did not take strong sanctions such as disapproving the contractor's cost-estimating system, even though he acknowledged that this action could be an effective motivator in correcting the deficiencies. According to the contracting officer, disapproving the estimating system (1) may have delayed the award of future contracts and (2) could have required the government to expend considerable effort in conducting its legal, cost analysis, and higher management reviews.

A third contractor had three significant cost-estimating system deficiencies reported by DCAA in September 1988 and March 1989. These deficiencies were (1) proposing material price quotations without considering historical cost information and failing to review proposed subcontract costs; (2) failing to consistently estimate specialized aircraft configuration costs; and (3) distorting historical costs used for estimating baseline and specialized configurations. In October 1992, the government and the contractor formed a joint team to find a satisfactory resolution to the two remaining uncorrected deficiencies. The team was told that the contracting officer would consider withholding progress payments or disapproving the cost-estimating system if the team was not successful. These sanctions were not used because, according to the contracting officer, the team was making satisfactory progress. However, as of January 31, 1994, almost 5 years later, the two deficiencies were still uncorrected.

Although DFARS provides criteria for evaluating the timeliness of the contractor's submission of a corrective action plan, DOD regulations do not provide specific criteria for evaluating the timeliness of the contractor's corrective action. Thus, we believe that DLA management must ensure that the time taken to correct long-standing deficiencies is reasonable and that contracting officer actions are appropriate.

DLA Lacks Adequate Controls to Ensure Timely Correction of Deficiencies

DLA's oversight of contracting officers was not adequate to ensure that significant cost-estimating system deficiencies were corrected in a timely manner or that contracting officers were taking all appropriate actions to obtain correction. The DOD/IG has reported similar problems. Recent DLA actions will not fully resolve these problems.

DOD Directive 7640.2 requires DOD to develop and evaluate contract audit follow-up systems to ensure the proper, timely resolution and disposition of audit reports. DLA implements the DOD directive through DLA Manual 8105.1, which designates DLA headquarters as responsible for managing audit follow-up activities. In turn, DLA headquarters relies on the district offices—which oversee individual contracting offices—to carry out these responsibilities. Specifically, district offices are responsible for (1) ensuring that procedures to report, track, and correct deficiencies are established and followed; (2) overseeing audit follow-up functions to ensure that all possible actions are taken to correct audit recommendations; and (3) providing guidance, training, and assistance on contract follow-up matters as required.

District Oversight Limited

The two district offices responsible for overseeing the DLA field office management of the three contractors periodically gathered data that showed the status of overaged⁶ cost-estimating system audits and the actions taken to close out the audits. Although district officials monitored the status of overaged cost-estimating system audit reports, they did not evaluate contracting officers' actions to assure that deficiencies were corrected in a timely manner. District officials told us they telephoned contracting officers to assure that the data field offices provided were current and that the contracting officers were taking some action. They said, however, that they did not evaluate the adequacy of those actions but instead left determination of the appropriate approach to the contracting officers and their supervisors. They said the contracting officer deals with the contractor frequently and has the most direct knowledge of the contractor.

District office officials can visit contractor locations to review a contracting officer's management of overaged audit reports. A district official told us that, among other things, site visits are to determine if the contracting officer was pursuing corrective action in a logical manner, whether there were long periods of inactivity, and whether the target dates seemed reasonable given the complexity of the deficiencies. However, district officials said they had not conducted site visits that focused on estimating system deficiencies at the three contractors.

District officials said they did not need to conduct such visits, in part, because they thought the contracting officers were making acceptable progress based on conversations that indicated the contracting officers were taking appropriate actions. However, one district official told us she was unaware of the age of long-standing deficiencies at two contractors because DOD's audit follow-up system contained incomplete information on the contractors. She said that, had she known of the true age of the deficiencies, she would have requested that district officials conduct a site visit.⁷

⁶In accordance with DOD Directive 7640.2, overaged audit reports are contract audits that are 12 months or more old that have not been corrected. DLA district offices track the status of contract audit reports—including those on estimating systems—from the time reports are received through final disposition. District offices report this information to DLA headquarters, which, in turn, submits a semiannual report to DOD/IG.

⁷In May 1992, we reported that the age of deficiencies in DOD's audit follow-up system was understated because audit follow-up system procedures required current reports to supersede earlier reports, even though the earlier deficiencies had not been corrected. See *Contract Pricing: DOD's Audit Follow-up System Is Inaccurate and Incomplete* (GAO/NSIAD-92-138, May 28, 1992).

DOD/IG Has Also Reported Inadequate Oversight of Contractors

Our findings regarding DLA's oversight of contractors are consistent with those reported by the DOD/IG.⁸ The DOD/IG evaluations of the audit follow-up activities of several defense agencies⁹ showed

- unjustified, lengthy periods of inaction by the responsible contracting officer;
- failure to assign priority to overaged reports;
- failure by contracting officers to use most of the regulatory remedies available under DFARS 215.811; and
- lack of active management oversight in determining the adequacy and timeliness of contracting officer actions to obtain correction of deficiencies.

In January 1994, these findings prompted the DOD/IG to emphasize that DOD management's responsibilities include monitoring contracting officer progress, determining reasons for delays, and reviewing milestones on a regular basis to ensure that contracting officers are aggressively pursuing open audit issues.

Planned DLA Improvements

During our review, DLA headquarters officials agreed that management oversight of contracting officer actions needed improvement, and they indicated they were considering some actions to address the problems. For example, DLA began compiling a database of contractors identified by DCAA as posing a high risk of defective pricing because of inadequate estimating systems. Headquarters officials said they planned to use this information to identify contractors and DOD contracting officers needing additional oversight by district offices. They also said they were planning to develop DLA headquarters policies and procedures describing how their oversight system would work. In addition, DLA planned to revise its policy manual, DLA Directive 8000.5, to emphasize the need for early and substantial contracting officer involvement in determining the adequacy of a contractor's estimating system.

⁸Audit Follow-up Oversight Review: Defense Contract Management Command Use of Documentation and Review Requirements for Audits of Contractor Estimating and Accounting Systems (AFU 94-01, Nov. 23, 1993); Contract Audit Follow-up Review of Supervisor of Shipbuilding Conversion and Repair (SUPSHIP) (CAFR-92-21, Aug. 11, 1992); and Memorandum for Director, DLA, on Analysis of Sept. 30, 1993, Contract Audit Follow-up Status Report, Jan. 6, 1994.

⁹The DOD/IG evaluations included DLA and Naval Sea Systems Command. DLA has jurisdiction for 27 of the high-risk contractors in our sample and Naval Sea Systems Command has responsibility for 2 contractors in our sample. The Army was responsible for one contractor in our sample.

Recommendation

We recommend that the Secretary of Defense direct the Director of DLA to implement procedures to ensure significant cost-estimating system deficiencies are corrected more expeditiously. Such procedures should include the implementation of routine follow-up by DLA district offices and headquarters to determine why long-standing deficiencies have not been corrected, and the establishment of specific time frames as to when contracting officers are required to seek guidance about using more severe remedies that are already available and when higher level management must become involved in finding solutions to such significant deficiencies.

Agency Comments

In its official comments to this report, DOD concurred with all the report's findings and recommendations. According to DOD, by October 1994, DLA will implement procedures to ensure that significant cost-estimating deficiencies are corrected in a more timely manner (see app. I).

Scope and Methodology

Our analysis of contractor cost-estimating system deficiencies and corrections and DOD contracting officers actions to encourage contractors to improve their estimating systems was based on a sample of 30 DOD contractors identified by DCAA as having high risk estimating systems. We interviewed DCAA officials and DOD contracting officers responsible for the 30 contractors and obtained documents related to the extent to which the significant deficiencies have been resolved. We used the information from the interviews and documents we obtained, together with a structured data collection instrument we developed, to identify the status of deficiencies and contracting officer actions to close out deficiencies for each of the 30 contractors.

To assess DLA's monitoring efforts to ensure that contracting officer actions are appropriate and timely in closing out deficiencies, we reviewed DOD regulations and DLA policy and guidance on appropriate contracting officer actions and on the timeliness of correction of significant estimating system deficiencies. We also interviewed DOD officials and reviewed DOD contract audit follow-up guidance and DOD/IG reports on DLA oversight activities. We also analyzed DOD's oversight of three contractors based on interviews with cognizant DOD personnel and analyses of DOD audit follow-up system reports.

We conducted our review between September 1992 and March 1994 in accordance with generally accepted government auditing standards.

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

Please contact me at (202) 512-4587 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, reading "David E. Cooper". The signature is written in a cursive style with a large, sweeping initial "D".

David E. Cooper
Director, Acquisition Policy, Technology,
and Competitiveness Issues

Comments From the Secretary of Defense



ACQUISITION AND
TECHNOLOGY

DP/CPF

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
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JUN 6 1994



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 entitled--"CONTRACT PRICING: DOD Management of Contractors With High-Risk Cost-Estimating Systems," dated May 2, 1994 (GAO Code 396809/OSD Case 9679). The Department concurs with the report.

The Department agrees with the GAO recommendation that more aggressive Government action is required to ensure contractors correct significant cost-estimating system deficiencies expeditiously. As noted in the GAO report, the Inspector General, DoD, recently completed a review of the procedures used by the Defense Contract Management Command covering resolution and disposition of audits of contractor estimating and accounting systems. In general, the Inspector General found an acceptable level of emphasis placed on contract audit followup throughout most of the Command. Nevertheless, the Inspector General made a number of recommendations to further improve followup practices. By October 1994, the Defense Logistics Agency will implement procedures to ensure that significant cost-estimating system deficiencies are corrected in a more timely manner.

The detailed DoD comments on the report findings and recommendation are provided in the enclosure. The Department appreciates the opportunity to comment on the draft report.

Sincerely,

Eleanor R. Spector
Director, Defense Procurement

Enclosure



Appendix I
Comments From the Secretary of Defense

GAO DRAFT REPORT--DATED MAY 2, 1994
(GAO CODE 396809) OSD CASE 9679

"CONTRACT PRICING: DOD MANAGEMENT OF CONTRACTORS
WITH HIGH-RISK COST-ESTIMATING SYSTEMS"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

FINDING A: Contractor Estimating Systems. The GAO observed those contractor estimating systems that produce reliable price proposals are a key safeguard to obtaining fair and reasonable contract prices. The GAO pointed out that Government administrative contracting officers are responsible for determining the adequacy of the contractor estimating systems--and, if the estimating system is deficient, for obtaining correction under DoD regulations. The GAO also reported that, if the Defense Contract Audit Agency reports cost-estimating system deficiencies, the Defense Federal Acquisition Regulation 215.811 requires contractors to disagree formally with the estimating system report--or, within 60 days of being notified of the deficiencies, to correct the estimating system deficiencies, or to submit corrective action plans. The GAO noted that if a contractor has not submitted an adequate corrective action plan or corrected significant deficiencies within 45 days after the contracting officer evaluation of the contractor 60 day response, the regulation authorizes contracting officers to disapprove the contractor estimating system--in whole or in part. The GAO explained that a notice of disapproval must be sent to each Defense contracting and contract administration office having substantial business with the contractor.

The GAO indicated that, after the contractor corrective action plan has been approved, contracting officers must monitor contractor progress in implementing the plan and correcting the deficiencies. The GAO pointed out that if the contractor does not make adequate progress in correcting deficiencies, the regulation authorizes the contracting officers to take actions to obtain correction--such as (1) reducing or suspending progress payments, (2) recommending nonaward of potential contracts, (3) referring the matter to high levels of DoD management, or (4) such other actions the contracting officer deems appropriate. (pp. 3-4/GAO Draft Report)

DOD RESPONSE: Concur.

Enclosure

Now on pp. 2 and 3.

Appendix I
Comments From the Secretary of Defense

FINDING B: Twenty Seven Percent of Deficiencies Remain Uncorrected. The GAO found that, as of January 31, 1994, the 30 contractors in the GAO sample had corrected or potentially corrected 85 of the 117 significant cost-estimating system deficiencies (73 percent). The GAO concluded, however, that the 32 outstanding deficiencies had been outstanding an average of 3.8 years.

The GAO also found that the Defense Logistics Agency had no specific criteria for evaluating the timeliness of the corrective actions of a contractor. Due to the complexity of many cost-estimating system deficiencies, the GAO learned that the Defense Logistics Agency allows contracting officers flexibility in determining whether a contractor is correcting a particular cost-estimating system deficiency in a timely manner.

The GAO observed that, when significant estimating system deficiencies exist, DoD officials must take steps to ensure that they negotiate fair and reasonable contract prices and to protect the Government against overpriced contracts. The GAO noted such steps can include (1) using additional cost analysis techniques to determine the reasonableness of the proposed prices, (2) allowing a contractor additional time to correct the cost-estimating system deficiency and to submit a corrected proposal, (3) reducing the negotiation objective for profit or fee, or (4) negotiating a contract clause that allows for adjustment of the contract amount after award. The GAO pointed out that the extra steps the DoD takes are frequently time-consuming and costly. (p. 2, pp. 4-7/GAO Draft Report)

DOD RESPONSE: Concur. The Department agrees that the determination of timeliness is largely subjective. The applicable DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," requires that all contract audit findings identifying deficiencies in contractor estimating systems be tracked and reported until resolved and dispositioned. The DoD Directive prescribes timeframes for resolution and disposition of estimating system survey audits and requires that the Inspector General, DoD, monitor, coordinate, and evaluate contract audit followup systems in the DoD. However, the Department permits some discretion in the recommended timeframes, because deficiencies are sometimes complex, and corrective actions can range from relatively simple policy revisions to major procedural changes, involving significant costs to the contractor. The key to obtaining timely correction is negotiating realistic milestones in the contractor corrective action plans. Thus, specific criteria to be applied across the board are not appropriate in determining whether or not corrective actions have been completed in a "timely" manner. Timeliness can only be fairly assessed by comparing actual performance to the milestones contained in the contractor corrective action plan.

Now on pp. 1 and 3-5.

FINDING C: Contracting Officers Did Not Use Their Strongest Regulatory Sanctions. The GAO found that 11 of the contracting officers included in the review were reluctant to use the strong sanctions provided by the Federal Acquisition Regulation--even though some contractors have had significant deficiencies outstanding for several years. The GAO reported that those 11 contracting officers used a variety of approaches to get corrective action after providing the contractor with the Defense Contract Audit Agency estimating system audit report and requesting that the deficiencies be corrected. The GAO pointed out that none of the contracting officers took the more severe steps allowed under the regulations--i.e., (1) reducing or suspending progress payments or (2) recommending nonaward of potential contracts. The GAO reported that, according to the contracting officers, using the more severe regulatory sanctions was not necessary because, in their opinion, the contractors were making adequate progress or because it would result in a legal challenge or affect the award of future contracts. (pp. 8-12/GAO Draft Report)

DOD RESPONSE: Concur. A decision to recommend nonaward of future contracts or suspend or reduce progress payments is a serious matter that requires consideration of the general equities of the situation and the possible effects on the financial condition and operations of the contractor. The DoD agrees that contracting officers should consider such actions if a contractor fails to correct system deficiencies. By October 1994, the Defense Logistics Agency will institute controls in its new contract administration manual to require that the strongest actions are carefully considered and, in those cases where warranted, used to ensure that contractors correct significant deficiencies.

FINDING D: The Defense Logistics Agency Lacks Adequate Controls to Ensure Timely Correction of Deficiencies. The GAO concluded the Defense Logistics Agency oversight of contracting officers was not adequate to ensure that significant cost-estimating system deficiencies were corrected in a timely manner--or that contracting officers were taking all appropriate actions to obtain correction. The GAO further concluded that recent Defense Logistics Agency actions would not fully resolve the problems. The GAO noted that, although Defense Logistics Agency district officials monitored the status of overaged cost-estimating system audit reports, contracting officer actions were not evaluated to assure that deficiencies were corrected in a timely manner. The GAO indicated that district officials did not evaluate the adequacy of the actions, but instead left determination of the appropriate approach to the contracting officers and their supervisors.

Now on pp. 6-8.

Appendix I
Comments From the Secretary of Defense

The GAO observed that the Inspector General, DoD, had found similar problems (Report AFU-94-01), reporting the following:

- unjustified, lengthy periods of inaction by the responsible contracting officer;
- failure to assign priority to overaged reports;
- failure by contracting officers to use most of the regulatory remedies available under the regulation; and
- lack of active management oversight in determining the adequacy and timeliness of contracting officer actions to obtain correction of deficiencies.

The GAO noted that, in January 1994, the findings prompted the Inspector General, DoD, to emphasize that DoD management responsibilities include (1) monitoring progress by contracting officers, (2) determining reasons for delays, and (3) reviewing milestones on a regular basis to ensure that contracting officers are aggressively pursuing open audit issues.

The GAO stated Defense Logistics Defense headquarters officials agreed that management oversight of contracting officer actions needed improvement and were taking some actions to address the problems. For example, the GAO reported that the Defense Logistics Agency was compiling a data base of contractors identified by the Defense Contract Audit Agency as posing a high risk of defective pricing because of inadequate estimating systems. (pp. 2-3, pp. 12-15/GAO Draft Report)

Now on pp. 1-2 and 8-10.

DOD RESPONSE: Concur. The Department agrees that more aggressive oversight of contracting officers actions to obtain timely correction of estimating system deficiencies is warranted. The Defense Logistics Agency has issued a number of directives to the Commanders of the Defense Contract Management Districts, requiring Commanders to become personally involved in assuring that contractors take action in correcting estimating system deficiencies and, if contractors fail to make adequate progress, bring the issue to the attention of higher level management. By October 1994, the Defense Logistics Agency will develop appropriate coverage for inclusion in its new contract administration manual that will identify specific district and headquarters oversight responsibilities. The manual will also include procedural guidance concerning estimating system reviews, and resolution and disposition of audit findings, including process controls. In addition, the Defense Logistics Agency database of contractors found to have significant deficiencies in their estimating systems will be used to identify those contractors that persistently are found to maintain less than adequate systems.

Appendix I
Comments From the Secretary of Defense

As a result of previous audit findings, the DoD Directive 7640.2, "Policy for Followup on Contract Audit Report," is being revised to provide management more information regarding the age of system deficiencies. Moreover, the Defense Logistics Agency has agreed to implement all of the recommendations in Inspector General, DoD, Report AFU-94-01, by incorporating additional guidance into its new contract administration manual, targeted for publication in October 1994.

* * * * *

RECOMMENDATION

RECOMMENDATION: The GAO recommended the Secretary of Defense direct the Director of the Defense Logistics Agency to implement procedures to ensure significant cost-estimating system deficiencies are corrected more expeditiously. The GAO indicated that such procedures should include (a) the implementation of routine follow-up by the Defense Logistics Agency district offices and headquarters to determine why long-standing deficiencies have not been corrected, and (b) the establishment of specific timeframes as to when contracting officers are required to seek guidance about using more severe remedies that are already available, and when higher level management must become involved in finding solutions to such significant deficiencies. (p. 16/GAO Draft Report)

DOD RESPONSE: Concur. By October 1994, the Defense Logistics Agency will implement procedures to ensure that significant estimating system deficiencies are corrected more expeditiously. Those procedures will include routine follow-up by Defense Logistics Agency district and headquarters staff to determine why long standing deficiencies have not been corrected. By October 1994, the Defense Logistics Agency will develop policy that will also require contracting officers, at specific timeframes and under certain conditions, to seek guidance concerning the use of more severe remedies and involve higher level management to ensure that contractors correct significant deficiencies.

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