



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

152060

National Security and  
International Affairs Division

B-257649

July 6, 1994

Rear Admiral Leonard Vincent  
Commander, Defense Contract  
Management Command

Dear Admiral Vincent:

In recent years, we have performed a number of reviews of defense contractor overhead costs. This work, along with audits by the Defense Contract Audit Agency (DCAA), shows that contractor submissions of unallowable and questionable costs remain a continuing problem. For example, in March 1994, we testified before the Senate Committee on the Budget that six small and two large defense contractors we reviewed included unallowable and questionable costs in their overhead claims. In addition to almost \$1 million in costs identified by DCAA at the six small contractors, we identified about \$2 million more in overhead costs that was either unallowable or questionable. Similarly, at the two large contractors, we identified about \$4.4 million in unallowable or questionable overhead costs. For fiscal years 1991 through 1993, DCAA questioned over \$3 billion in contractor overhead costs.

In an attempt to deter contractors from including unallowable costs in their overhead submissions, Congress legislated a penalty provision in the Department of Defense Authorization Act, 1986, 10 U.S.C. 2324. Amended in 1992, in its current form, the penalty provision states, in general, that for all Department of Defense (DOD) flexibly-priced contracts over \$100,000, DOD can levy a penalty against contractors for including expressly unallowable costs in their overhead cost submissions.

The Chairman of the Senate Budget Committee asked us to ascertain the extent to which DOD uses the penalty provision. However, given the fact that the October 1992 changes to the penalty law have been in effect a short

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period of time, the Chairman subsequently asked us to defer our review.

Based on the work we performed on our current effort, we found that the information that the Defense Contract Management Command (DCMC) collected on the use of penalties was limited and was manually organized and summarized.<sup>1</sup> While we understand that the objective of DCMC's data collection was to obtain a general understanding of the amounts of penalties demanded and collected, we believe that a more complete and better organized system for collecting and analyzing penalty information would be cost beneficial both as a basis for DCMC oversight and for future assessments by us. This is particularly true in view of the continuing congressional interest in DOD's use of the penalty provision, the likelihood that we will be requested to review this issue again, and the potentially significant amounts involved.

#### DCMC DATA ON CONTRACT COSTS SUBJECT TO PENALTY

In 1992, DCMC attempted to obtain a general understanding of the amount of penalties demanded and collected. Between October 1992 and March 1993, DCMC sent a series of memorandums to its district offices requesting information on penalties. DCMC required that administrative contracting officers (ACOs) submit quarterly data in a prescribed format--including the amount of overhead costs questioned by DCAA subject to penalty, the amount of questioned costs ACOs sustained as expressly unallowable, the amount of penalties demanded of contractors, and the amount of penalties collected from contractors. DCMC headquarters manually recorded the quarterly data and calculated quarterly totals by district and a cumulative total for calendar year 1993.

Although this data collection effort provided an estimate of penalties demanded and collected, we believe its usefulness was limited because (1) the reports resulting from the manual method used to record completed cases cannot be readily analyzed to determine the number of cases with penalties waived or no penalties demanded, and (2) the data DCMC initially provided to us was not complete.

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<sup>1</sup>DCMC estimated that for calendar year 1993, \$2.6 million in penalties were demanded and \$1.6 million were collected.

A MORE FORMAL SYSTEM FOR MAINTAINING PENALTY DATA MAY HELP DCMC MANAGE DOD CONTRACTING OFFICERS' USE OF THE PENALTY PROVISION

Although DCMC was, after several requests, able to provide more complete data, we believe that establishing a more organized system for recording and maintaining penalty information that uses data from DCAA's management information system to confirm DCMC totals could help DCMC effectively monitor and provide more reliable information about DOD contracting officers' use of the penalty provision.

Both DCAA and DCMC officials told us that DCAA's management information system includes data on the number of DCAA overhead cost audits where DCAA recommended that penalties be demanded. This data as currently provided to DCMC could be used to verify the completeness of the data DCMC collects from ACOs to ensure that all audits with costs questioned subject to penalty are considered.

In addition, until October 1992, DCAA's system also identified the total dollar amount of costs questioned subject to penalty. For audits initiated as of fiscal year 1992, DCAA no longer tracks this data. We believe that information on the amount of costs questioned subject to penalty, factored for costs allocable to covered government contracts, would also be of value to you and we suggest that you ask DCAA to include this information in its system.

RECOMMENDATIONS

In view of continuing congressional concerns over unallowable overhead cost submissions and the use of penalties, we recommend that you establish a more organized system to record and maintain penalty information and use DCAA data to verify the completeness of the data collected.

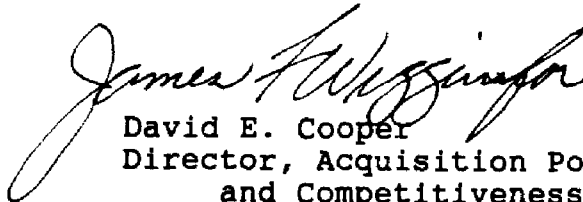
We did not obtain written agency comments. However, we discussed a draft of this letter with officials from DCMC, DCAA, DOD Office of the Inspector General, and the Office of the Director of Defense Procurement. They agree that some action should be taken to institute a more formal penalty tracking process. We have incorporated their comments where appropriate.

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We would appreciate being informed of any actions you take to address the issues discussed in this letter. We would be happy to discuss with you or your staff the types of information we believe are needed to evaluate the use of the penalty provision. We are sending a copy of this letter to the Director, DCAA, and the Chairman, Senate Budget Committee. Copies will be made available to others upon request.

The principal staff members responsible for this letter were John L. Carter, Leslie E. Schafer, and Charles W. Thompson. If you have any questions, please call me on (202) 512-4587.

Sincerely yours,



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

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