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CONTRACT PRICING

**Improving Defense
Management and Oversight**

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Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the results of our recent work on Department of Defense (DOD) contract pricing--with a special emphasis on subcontract pricing issues. As you know, a few years ago we identified defense acquisition as a "high risk" area where weak contractor controls and poor DOD management information made the government vulnerable to fraud, waste, and abuse. Within the defense acquisition area, we have continued our audit efforts, at your request, to assess the government's vulnerability to contract overpricing and to evaluate DOD's efforts to address it.

Last year before this committee, I pointed out that DOD contracts were overpriced by billions of dollars. In response, DOD took several steps in an attempt to deal with the problems we identified. While these steps were positive, the results of our most recent work show that those steps were not enough. Contractor compliance with existing laws and regulations is still inadequate and the government remains at a high risk.

Our most recent reports to you, issued over the last few weeks (see list of products at the end of this statement), show that:

- Identification of contract overpricing by the Defense Contract Audit Agency (DCAA) declined in frequency in 1991, but still cost the government hundreds of millions of dollars last year. Overpriced subcontracts posed a major problem.
- As a result of recent changes in the way DCAA identifies high risk contractors, some contractors may receive reduced audit coverage even though they have a history of frequent and significant overpricing.
- DCAA is unaware of many subcontracts subject to audit under the Truth in Negotiations Act.
- Some DOD contracting officers are not ensuring that contractors correct problems that have led to overpricing, and information on high risk contractors in DOD's audit follow-up system is inaccurate and incomplete.

With that overview, let me talk about the importance of good management controls and then discuss, in more detail, the results of our recent reviews and close with our views on what needs to be done to correct the problems we found.

IMPORTANCE OF MANAGEMENT CONTROLS
IN ASSURING FAIR AND REASONABLE PRICES

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 to inflated contract prices in such situations, the Congress passed the Truth in Negotiations Act in 1962. The act, codified at 10 U.S.C. 2306a, requires prime contractors and subcontractors to submit cost or pricing data supporting their proposed prices and to certify that the data are accurate, complete, and current.

DCAA is responsible for conducting audits, called defective pricing audits, to determine whether contractors comply with the act. If contract prices are found to be higher than warranted because of contractors' failure to provide accurate, complete, or current data, the act provides the government with a legal basis to recover the overstated amounts. These DCAA audits thus provide an important management control within DOD's procurement process. The results of these audits are entered in DCAA's management information system, where the data can be used to provide perspective on the extent of defective pricing and to identify where recurring problems may exist.

In March 1988, in response to our reports and other audit reports showing evidence of significant overpricing, DOD revised its regulation to require major contractors to establish, maintain, and disclose adequate cost-estimating systems. The regulation provides that DCAA, along with contract administration personnel, regularly audit (generally every 3 years) the adequacy of contractor estimating systems. According to DOD, this regulation represents its most significant action for ensuring that contractor proposals include all the information necessary to establish fair and reasonable contract prices.

IDENTIFICATION OF DEFECTIVE PRICING
DECLINES, BUT REMAINS SIGNIFICANT

Despite the existence of laws and regulations designed to protect the government, defectively priced contracts continue to be significant. We analyzed the results of over 11,000 defective pricing audits completed by DCAA during fiscal years 1987-91. These audits covered contracts totaling \$443 billion. During this 5-year period, DCAA found \$3.7 billion in defective pricing. Identification of defective pricing increased each year from 1987 to reach a high of \$897 million in 1990. In 1991, DCAA-identified defective pricing declined to \$731 million.

During the 5-year period, the frequency of findings of defective pricing declined. In 1987, about half of DCAA's audits identified defective pricing; in 1991, it was about 20 percent.

In spite of these declines, the amount of defective pricing reported by DCAA remains significant, particularly for a limited number of contractors. During fiscal years 1987-91, 116 contractors, or about 6 percent of those audited, accounted for 80 percent of the reported defective pricing. In fiscal year 1991 alone, 26 contractors, or about 3 percent of those audited, accounted for 80 percent of the reported defective pricing, with one of these contractors accounting for over half of the reported defective pricing.

SUBCONTRACTS POSE A MAJOR RISK FOR DEFECTIVE PRICING

While the government is at risk for overpricing in prime contracts, it is particularly at risk in subcontracts, where DOD relies heavily on the prime contractor and the quality of its cost-estimating system to assure reasonable subcontract prices.

We estimate that \$1.85 billion, or 63 percent of all defective pricing identified by DCAA in fiscal years 1987-90¹ was related to overstated subcontract prices.

DCAA identifies overstated subcontract prices in two main ways. One way is when subcontractors fail to provide accurate, complete, and current cost or pricing data to prime contractors, and, as a result, overstate subcontract prices. DCAA finds this kind of defective pricing in its audits of individual subcontractors. Based on these audits, during fiscal years 1987-90, DCAA reported about \$880 million in subcontract defective pricing.

The second way in which overstated subcontract prices occur is when prime contractors have accurate, complete, and current data related to subcontract prices, but fail to provide it to the government, and, as a result, overstate subcontract prices. DCAA finds this kind of defective pricing in its audits of prime contractors. Because DCAA does not break this information out separately in its reports from other defective pricing, we reviewed a random sample of prime contract audits to obtain an estimate of prime contract defective pricing resulting from overstated subcontract prices.

We found that nearly half of the prime contract defective pricing reported during the 4-year period was related to overstated subcontract prices. DCAA audits of prime contractors found \$2.1 billion in defective pricing for the period; we estimate that \$970 million of this was related to subcontracts. When this

¹At the time of this analysis, DCAA's fiscal year 1991 defective pricing data was not available. Other analyses included in this testimony include DCAA's fiscal year 1991 defective pricing data.

amount is added to the \$880 million in reported subcontract defective pricing, defective pricing related to subcontracts amounts to an estimated \$1.85 billion.

We believe that this analysis corroborates what we reported to you last year--DOD is vulnerable to defective pricing in prime contracts, but is particularly vulnerable regarding the pricing of subcontracts. This reinforces the importance of an effective subcontract defective pricing program by DCAA and the need for sound contractor cost-estimating systems. I will have more to say on DCAA's subcontract defective pricing program later in my testimony.

I would now like to discuss work we have done to examine the adequacy of DOD's oversight of contractors in terms of (1) identifying and auditing high-risk contractors and (2) assuring effective and timely action when cost-estimating problems are found.

CHANGES IN DCAA'S RISK ASSESSMENT
PROCEDURES REDUCES THE NUMBER OF
CONTRACTORS DESIGNATED AS HIGH RISK

DCAA assesses contractors annually to determine their risk for defective pricing. DCAA uses the results of this assessment to determine which contracts to audit since it does not have the resources to examine all contracts. In general, the higher the risk, the higher the audit coverage.

In fiscal year 1992, DCAA modified its approach for determining whether contractors pose a high risk of defective pricing. Previously, a contractor was identified as high risk if it (1) had a high incidence of defective pricing findings, (2) had chronic estimating system deficiencies, or (3) was suspected of fraud. Under its modified approach, DCAA expanded the categories² by which it evaluated contractors and it based its assessment of risk on an average rating on all evaluation categories. For example, in fiscal year 1991, if a contractor was considered high risk in any of the three factors, the contractor was identified as high risk. However, for fiscal year 1992, a contractor was given a score of 1 (low risk) to 4 (highrisk) for each of the four categories. Each of the four scores is added and the sum divided by four to obtain an overall contractor rating. A contractor was identified as high risk if it had an average score of more than 3. Thus, contractors considered high risk in the two defective pricing categories but

²The categories used in fiscal year 1992 were (1) adequacy of cost-estimating systems, (2) adequacy of accounting systems, (3) frequency of reported defective pricing, and (4) amount of reported defective pricing.

lower risk in the other two categories, could be identified as less than high risk when the results were averaged. This happened in a number of instances.

DCAA's change in its risk assessment methodology substantially reduced the number of contractors it classified as high risk. In fiscal year 1991, DCAA identified 65 contractors as high risk. In fiscal year 1992, DCAA designated only 10 contractors as high risk. However, this decrease does not mean that the risk of defective pricing for selected contractors went down as might be suggested by comparing fiscal years 1991 and 1992. In fact, when we analyzed the evaluation factors separately, we found that the number of high risk contractors went up. For example, for fiscal year 1992, DCAA designated 96 contractors, 48 percent more than in fiscal year 1991, as high risk in at least one of three evaluation factors--cost-estimating system deficiencies, incidence of defective pricing, or amount of defective pricing identified in DCAA reports. However, when DCAA averaged the individual scores for these 96 contractors, only 10 were identified as high risk.

To further illustrate the effect of DCAA's revised risk assessment procedure, we compared the 26 contractors which accounted for 80 percent of the reported defective pricing in fiscal year 1991 with DCAA's fiscal year 1992 list of high risk contractors. We found that only one of these 26 contractors was considered high risk for defective pricing. For example, the contractor with the largest amount of reported defective pricing in fiscal year 1991--\$388 million--was considered by DCAA as medium-high risk. This contractor represented 53 percent of all defective pricing reported by DCAA in fiscal year 1991 and was identified as high risk by DCAA in both fiscal years 1990 and 1991. The second highest reported contractor had potential defective pricing of about \$25 million. This contractor was also considered by DCAA as medium-high risk.

When a contractor is not identified as high risk, the chances of its contracts being audited are reduced. For example, if a contractor is considered high risk, DCAA guidance calls for auditing all negotiated fixed-price contracts between \$10 million and \$25 million, but if a contractor is considered a medium-high risk, which is one level below high risk, the guidance calls for auditing only half of these contracts.

MANY SUBCONTRACTS ARE NOT IDENTIFIED FOR AUDIT CONSIDERATION

In auditing contracts for defective pricing, it is important that DCAA allocate its resources to contracts with the highest risk. This requires that DCAA be aware of the universe of both prime

contracts and subcontracts subject to audit. There is a centralized DOD data base on prime contracts; however, there is not similar data base on subcontracts.

Because subcontracts are so significant and represent a major risk for defective pricing, we wanted to determine the extent to which DCAA is aware of the universe of subcontracts subject to audit under the Truth in Negotiations Act. We examined 211 negotiated subcontracts contained in 4 prime contracts-- 2 from the Air Force and 1 each from the Army and Navy. 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 subcontracts in our sample. The 186 subcontracts were worth about \$189 million, or 56 percent of the total value of subcontracts in our sample.

There are several reasons why DCAA auditors are not aware of subcontracts. First, and most significant, DCAA offices have no comprehensive information source that identifies all subcontracts subject to defective pricing audits. Prime contractors are not required to provide DCAA with lists of their subcontracts that are subject to DCAA audit and available sources are incomplete and frequently incompatible. Second, when DCAA field offices become aware of subcontracts during their audits of prime contracts, they do not pass this information to the field offices with responsibility for the subcontracts. Only one of the three DCAA offices responsible for the four prime contracts we reviewed consistently shared this information. DCAA does not require its field offices to provide this information to other offices.

Unless DCAA knows of all subcontracts subject to audit and assesses the risk of defective pricing on each, it cannot ensure that its audit resources are being appropriately applied to subcontracts with the greatest risk of defective pricing. Also, by not being aware of all subcontracts, DCAA will understate the resources it needs for its defective pricing program.

ACTIONS BY CONTRACTING OFFICERS ARE MIXED

Last year, we reported that many cost-estimating deficiencies remained uncorrected for long periods of time despite a 1988 revision in DOD's regulation requiring major contractors to establish adequate cost-estimating systems. To follow-up on whether DOD's administrative contracting officers were taking steps to resolve subcontract cost-estimating deficiencies in a timely manner, we examined actions by 11 defense contractors. We found mixed results.

Six of the 11 contractors had taken substantive actions to correct almost all (32 of 33) of their subcontract estimating deficiencies. However, the other five had only effectively dealt with about one-third (10 of 28) of their deficiencies. Over half (33 of 61) of all the deficiencies were not corrected in a timely³ manner.

One reason for the untimely correction of deficiencies was that DOD contracting officers took inadequate actions or did not follow established procedures. For example, some contracting officers considered deficiencies to be corrected primarily on the basis of promised contractor actions. We found that, too often, the promised actions were either not implemented or proved inadequate. If DOD is to reduce the risks of overpriced contracts, it needs more thorough reviews by its contracting officers.

DOD'S AUDIT FOLLOW-UP SYSTEM ON COST-ESTIMATING
SYSTEM REPORTS IS INACCURATE AND INCOMPLETE

DOD's audit follow-up system is a key component of its oversight of contractors with cost-estimating problems. In May 1991, DOD testified before this Committee that its audit follow-up system provided DOD management with the necessary insight into both prime contractor and subcontractor pricing problems. DOD noted that deficiencies in 92 percent of 555 estimating system reports had been resolved in a timely manner.

To evaluate the DOD follow-up system, we determined whether DCAA cost-estimating reports on 49 contractors that it had identified in fiscal year 1991 as high risk because of chronic estimating system deficiencies were accurately included in the system. We found that the system did not provide accurate and complete information on the condition of cost-estimating systems for 35 (or 71 percent) of these high risk contractors. The system was missing 12 reports which were issued on 13 contractors, understated the length of time reported deficiencies had remained uncorrected for 17 contractors, and showed that 5 contractors had completed corrective action when they had not.

³We classified DOD's efforts to correct reported estimating deficiencies as untimely when our case-by-case assessment identified unnecessary delays in evaluating corrective action plans and monitoring progress toward correcting the deficiencies. In general, these deficiencies remained uncorrected for a year or more.

DOD HAS TAKEN STEPS
TO ADDRESS PAST PROBLEMS

Since last year's hearing, DOD has taken a number of actions designed to improve its management and oversight of contractors with cost-estimating system deficiencies. For example, DCAA issued guidance designed to improve its estimating system reports to contracting officers, and the Defense Logistics Agency issued guidance to its district and field offices emphasizing the importance of motivating contractors to comply with DOD regulations. More recently, the DOD Inspector General took steps designed to improve the accuracy and completeness of data in the audit follow-up system. These, and other positive actions, should, if properly implemented, increase assurances that cost-estimating deficiencies are corrected in a timely manner.

RECOMMENDATIONS

Contract overpricing amounting to billions of dollar continues to plague the DOD procurement system despite the existence of laws and regulations designed to prevent such overpricing. While DOD has taken steps to address overpricing problems, additional actions are needed. Our recent reports to you contain recommendations designed to help DOD overcome these problems.

DOD needs to strengthen its oversight systems. Most importantly, DCAA needs to have the means to identify all subcontracts subject to the Truth in Negotiations Act. It currently does not. We recommend that DOD examine the costs and benefits of changing the Federal Acquisition Regulation to require prime contractors to provide subcontract information to DOD so that DCAA can adequately assess subcontract risk for defective pricing and allocate its resources accordingly.

DOD contracting officers are a front line of defense against contract overpricing. They need to be more aggressive in their efforts to get contractors to correct cost-estimating deficiencies. Using a contractor's action plan as the basis for dismissing DCAA audit findings, as some contracting officers now do, is inappropriate. The proof is in the effective implementation of sound plans, not in the fact that plans were written. We recommend that DOD ensure that administrative contracting officers verify that contractors have corrected all deficiencies cited in DCAA cost-estimating reports before reporting disposition of the audit.

DOD needs to also focus on those contractors who have a history of significant defective pricing or chronic cost-estimating systems deficiencies. They need to identify why these contractors continue to have these problems and take steps to assure that they are corrected. We recommend that DCAA revise its fiscal year 1992 procedure for designating contractors as

high risk to ensure that those contractors that have historically posed the greatest risk of defective pricing are included in the group of contractors that, for audit and management oversight purposes, are identified as high risk and receive appropriate attention.

Finally, we are recommending that DCAA increase the resources it devotes to defective pricing audits. It is currently examining too few contracts and subcontracts. All contractors that have a history of significant defective pricing or chronic cost-estimating system problems should be identified as high risk and should receive intense DCAA audit coverage. Increasing DCAA resources for defective pricing should not require an increase in overall DCAA staffing. Currently, DOD is planning to reduce DCAA staffing consistent with reductions in defense contracting activity. We believe that DCAA staff reductions should be limited so as to allow it to increase its coverage of defective pricing and other areas of risk.

Mr. Chairman, that completes my statement. I will be pleased to answer any questions you or the members of the Committee have.

RELATED GAO REPORTS

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

Contract Pricing: Subcontracts Are Significant in Prime Contract
Defective Pricing (GAO/NSIAD-92-131, May 28, 1992).

Contract Pricing: DCAA's Methodology Change in Identifying "High
Risk" Contractors (GAO/NSIAD-92-183, June 2, 1992).

Contract Pricing: DCAA's Audit Coverage Lowered By Lack of
Subcontract Information (GAO/NSIAD-92-173, May 29, 1992).

Contract Pricing: Estimating Deficiencies Resolved Slowly, but
Recent DOD Actions Should Help (GAO/NSIAD-92-187, May 28, 1992).

Contract Pricing: DOD's Audit Follow-up System Is Inaccurate and
Incomplete (GAO/NSIAD-92-138, May 28, 1992).

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