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United States General Accounting Office

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

July 1993

CONTRACT PRICING

Issues Related to DCAA Staff Levels



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**National Security and
International Affairs Division**

B-253759

July 1, 1993

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

Dear Mr. Chairman:

This report responds to your request that we comment on the possible effects of recent reductions in the Defense Contract Audit Agency (DCAA) staffing levels on DCAA's ability to protect against fraud, waste, and mismanagement. As agreed with your staff, this report summarizes and updates our prior work on contract pricing issues related to DCAA staffing needs.

Results in Brief

With the downsizing of the defense budget—in particular, the procurement component—DCAA's staffing has been significantly reduced from its peak of 7,030-work years in fiscal year 1990 to 5,650-work years in fiscal year 1993. For fiscal year 1994, the President's budget proposed a 70-work year increase in DCAA staffing to 5,720.

DCAA must have sufficient audit resources to protect the government from the risk of overpriced contracts. Although we recognize that the decline in the Department of Defense (DOD) contracting will reduce the need for certain types of DCAA audits, we believe that the debate on the appropriate number of DCAA staff should consider that there are areas of contract risk that remain and need to be adequately addressed. The following are four areas of particular risk:

- ensuring adequate review of subcontractors for defective pricing,
- ensuring that the government is protected from unnecessary contractor overhead costs,
- reducing the substantial backlog of audits of contractor incurred costs, and
- ensuring adequate levels of transaction testing (tracing expenditures back to supporting documentation and evaluating their allowability) to detect unallowable contractor cost submissions.

Background

DCAA was established in 1965 by consolidating the existing audit organizations of the military services. DCAA audits defense contracts and

provides accounting and financial advisory services to DOD procurement and contract administration activities. Its audits support the negotiation, administration, and settlement of DOD contracts. DCAA also performs contract audit services for non-DOD government agencies.

DCAA's work load is driven primarily by the volume of DOD contracting. DCAA allocates significant resources to

- forward pricing audits, which evaluate the reasonableness of contractors' proposed contract costs and the soundness of the systems that generate those costs;
- defective pricing audits, which determine whether noncompetitive contract prices were improperly increased because contractors did not provide the government with accurate, complete, and current cost or pricing data; and
- incurred cost audits, which evaluate whether the costs that contractors charge to government contracts are allowable, allocable, and reasonable.

DCAA also performs a number of other types of audits, including operations audits, a specific type of incurred cost audit that evaluates the economy and efficiency of contractors' operations.

DCAA Staffing Levels Since Fiscal Year 1980

Between fiscal years 1980 and 1990, DCAA's staffing doubled from about 3,500 to a peak of 7,030-work years. However, beginning in fiscal year 1991, staffing began to decline and reached 5,650-work years in fiscal year 1993. The 1994 President's budget proposed a funding level of \$355.4 million for DCAA plus \$44.7 million for other agencies to reimburse DCAA for audits of non-defense contracts. This budget will support a staff level of 5,720-work years—an increase of 70-work years over the fiscal year 1993 staff level.

DOD contracting also declined in recent years. The total amount of prime contracts over \$25,000 awarded by DOD increased from about \$75 billion in fiscal year 1980 to \$150.7 billion in fiscal year 1985. The amount then declined to \$121.4 billion in fiscal year 1992, the last full year for which data is available.

Areas of Contract Risk Remain

Over the last few years, we have identified several areas of contract risk that need to be more adequately addressed by DCAA.

Defective Pricing May Be Greater Than DOD Realizes

Defective pricing audits are an important safeguard against the government paying inflated contract prices. Between fiscal years 1987 and 1991, DCAA audits identified overpricing of \$3.67 billion.¹ However, the risk of defective pricing may be greater than DOD realizes because DCAA is not aware of many subcontracts subject to defective pricing audits.

The risks associated with subcontracts are substantial. In fiscal years 1987-1990, DCAA reported defective pricing in 43 percent of the subcontracts it audited. DCAA identified \$880 million in potential subcontractor defective pricing—about 30 percent of the total potential defective pricing reported in fiscal years 1987-1990.² In our recent report to you,³ we found that DCAA was unaware of 88 percent (186 of 211) of a sample of subcontracts because it did not have an effective system to identify them. Without being aware of all subcontracts, DCAA cannot be aware of the full extent of the defective pricing problem.

In response to our report, DOD proposed a change to the Federal Acquisition Regulation (FAR) requiring defense contractors to provide DCAA with listings of all subcontracts subject to audit. However, the FAR change has not yet been implemented. In the interim, DCAA has directed its regional directors to request from all major and large nonmajor contractors a complete list of prime contracts and subcontracts they are performing that are subject to the Truth in Negotiations Act. In addition, field audit offices were instructed to notify the responsible audit office of any subcontracts subject to the Truth in Negotiations Act that they found during their programmed audits.

Operations Audits May Reduce Government's Risk of Paying Unnecessary Contractor Overhead Costs

The Defense Contract Management Command (DCMC) recognizes increasing overhead costs as a problem area. In January 1993, the Commander of DCMC notified the Commanders of the Defense Contract Management Districts that contractor overhead costs should be a major issue bearing their personal attention. The Commander stated that DCMC needed to be proactive in seeing that excessive contractor overhead costs are not priced into or reimbursed on DOD contracts.

¹Contract Pricing: Status of Defective Pricing (GAO/NSIAD-92-184FS, May 21, 1992).

²Contract Pricing: Subcontractor Defective Pricing Audits (GAO/NSIAD-91-148FS, Mar. 21, 1991).

³Contract Pricing: DCAA's Audit Coverage Lowered by Lack of Subcontract Information (GAO/NSIAD-92-173, May 29, 1992).

DCAA's operations audits are designed, in part, to evaluate the economy and efficiency of contractor functions or operations, such as overhead factors. These reviews have resulted in recommendations to eliminate unnecessary costs or waste, which, in turn, reduce DOD contract costs.

In our October 1991 report, we stated that although operations audits have had substantial payback, DCAA has decreased the number of operations audits it performs.⁴ We recommended that DCAA increase the priority it gives to operations audits. Examples of savings resulting from these audits include one that saved the government \$13.6 million through DCAA's recommendations regarding the contractor's health care plans. An operations audit of a contractor's inventory control system saved the government \$5.5 million annually.

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

The resources devoted to these audits continue to decline. Actual hours expended declined from 80,131 (about 53-work years) in fiscal year 1991 to 63,683 (about 42-work years) in fiscal year 1992. The midyear staff hours used for operations audits in fiscal year 1993 were 25,119 hours (about 17-work years).

Backlog of Incurred Cost Audits Needs to Be Addressed

Incurred cost audits evaluate whether the costs that contractors charge to government contracts are allowable, allocable, and reasonable. Although incurred costs must eventually be audited, DCAA considers incurred cost audits as self-initiated audits that can be deferred in order to balance its work load with staff availability.

The DOD Inspector General (IG) has reported that deferring incurred cost audits may adversely impact the government.⁵ For example:

- Contractors may use historical costs containing unallowable, unallocable, or unreasonable costs in negotiating future contracts with the government.

⁴Contract Pricing: Economy and Efficiency Audits Can Help Reduce Overhead Costs (GAO/NSIAD-92-16, Oct. 30, 1991).

⁵Report on Oversight Review of the Defense Contract Audit Agency Backlog of Incurred Cost Audits (APO 89-021).

- Deferring in-depth reviews of sensitive cost areas (1) increases the government's vulnerability to financial irregularities and (2) delays the government's corrective action to prevent contractors from incurring excessive costs.
- Until an incurred cost audit is completed, the government does not know whether its interim payments to contractors are overstated or understated.

The DCAA Director expressed similar concerns in his May 1, 1992, memorandum to the Secretary of Defense addressing DCAA's Program Objective Memorandum submission for fiscal years 1994-1999.

While defense contracting increased during the early 1980s, DCAA staffing was not able to keep pace with it, and DCAA's backlog of unaudited incurred costs grew to \$170 billion by the end of fiscal year 1989. More recently, DCAA increased its audits of incurred costs—expending 2,294-work years in fiscal year 1990 and 2,139-work years in fiscal year 1991. By September 1992, its backlog was reduced to \$142 billion. DCAA estimates it will be able to reduce the incurred backlog to \$64.6 billion at the end of fiscal year 1997 and reduce the work years expended in this area to 1,411 in fiscal year 1997.

If its estimates are accurate, DCAA would reduce its incurred cost backlog to a level equal to one year's inventory of audits, which, according to the DOD/IG, is a reasonable level. However, last year the DOD/IG questioned DCAA's incurred costs audit estimates and pointed out that DCAA's productivity forecast—in terms of dollars examined per work year—has historically been overstated by 11 percent. According to the DOD/IG, if this overstatement of the productivity factor continued, it would increase the fiscal year 1995 end-of-year inventory of incurred costs by over \$35 billion.

DCAA's current estimate shows productivity rates higher than those questioned by the DOD/IG. DCAA estimates fiscal year 1996 productivity at \$50.6 million examined per work year and its fiscal year 1997 productivity at \$52.2 million per work year. The rates the DOD/IG questioned ranged from \$44.4 million to \$49.1 million per work year.

Need for Increased Efforts to Identify Unallowable Costs

Last year, we reported that limited DCAA transaction testing of contractor overhead cost submissions may have contributed to DCAA's failure to identify unallowable costs.⁶ We pointed out that the depth of DCAA's audits

⁶Contract Pricing: Unallowable Costs Charged to Defense Contracts (GAO/NSIAD-93-79, Nov. 20, 1992).

at some contractors we reviewed was not sufficient to identify significant amounts of unallowable or questionable costs.

We recommended that the Director, DCAA, evaluate the extent to which field offices need to spend more time in transaction testing, especially at smaller contractors. We recognized that DCAA did not have the resources to make in-depth reviews at small contractors each year, and recommended that DCAA consider detailed in-depth reviews of contractors' incurred costs every 3 or 4 years.

DCAA responded to our report by taking actions intended to improve audit performance at smaller contractors. Most of DCAA's improvements related to improving DCAA audit guidance and improved training for DCAA auditors.

Scope and Methodology

Information on DCAA staffing levels and audit work load was obtained from DCAA headquarters. Information on the potential effects of DCAA staff reductions was summarized from previously issued GAO and DOD/IG reports and testimonies.

As arranged with your office, we did not obtain written agency comments. However, we discussed this report with agency officials. DCAA officials stated they believe DCAA's projected resources are adequate to address the contract pricing risks currently known to DCAA. We believe our past work and the DOD/IG show that some areas of contract pricing risk may be greater than DCAA currently projects. Other agency comments were incorporated in this report where appropriate. We conducted our review between April 1993 and June 1993 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 Director, DCAA; the Director, Office of Management and Budget; and other interested congressional committees. Copies 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 were Charles W. Thompson, Assistant Director, and John L. Carter, Evaluator-in-Charge.

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 distinct "M".

Paul F. Math,
Director, Acquisition Policy, Technology
and Competitiveness Issues

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