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GAO

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General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-242859

June 10, 1993

Mr. William H. Reed, Director
Defense Contract Audit Agency



149353

Dear Mr. Reed:

In June 1992, the Chairman, Senate Committee on Governmental Affairs, held hearings on Department of Defense (DOD) management and oversight of contractors and released six GAO reports that addressed the adequacy of controls for preventing fraud, waste, and mismanagement in DOD contracting. One report dealt with subcontracting by prime contractors¹ and discussed our review of certain Defense Contract Audit Agency (DCAA) defective pricing reports. The purpose of this correspondence is to bring to your attention an additional concern related to reporting the systemic nature and causes of defective pricing that we noted during our earlier review.

Under certain circumstances, DCAA's Defense Contract Audit Manual (DCAM) requires DCAA's defective pricing reports to address the systemic nature and causes of defective pricing; however, we found that the DCAM does not provide sufficiently specific guidance about when to use these provisions. As a result, some of the reports we reviewed did not include the language suggested by the DCAM provision. These reports did not

- refer to prior cost estimating system reports describing conditions causing the defective pricing or
- express an opinion whether the conditions leading to the defective pricing cited were systemic.

¹Contract Pricing: Subcontracts are Significant in Prime Contract Defective Pricing.

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DCAA DEFECTIVE PRICING REPORTS DO
NOT ALWAYS ADDRESS SYSTEMIC ISSUES

DCAM para. 10-605.4 a. instructs DCAA auditors, in preparing defective pricing reports, on reporting any unsatisfactory conditions or questionable practices found in the contractor's operations. The auditor's decision to report the condition or practice causing the defective pricing depends on the auditor's judgement on the seriousness of and on how often the matter has been reported in the past. (The criteria that we used to assess seriousness are shown in appendix I). If a prior cost-estimating system report has not cited the condition, according to the DCAM, the defective pricing report should present the condition, along with the related recommendation. If a previous cost estimating system report describes the condition that caused the defective pricing, according to the DCAM, the defective pricing report should refer to that estimating system report.

DCAM para. 10-605.4 b. provides that to promote consistency in resolving cases where the cited condition is systemic, or other reports present the same condition, defective pricing reports should express an opinion that the condition is systemic and, if previously reported, list the other reports citing the same condition. The DCAA headquarters defective pricing program manager told us he would expect the opinion called for by DCAM para. 10-605.4 b. to be included if the condition had been cited in one other defective pricing report issued to a different procuring contracting officer, and the condition is systemic.

The defective pricing program manager also said that including the information called for by DCAM paras. 10-605.4 a. and b. in defective pricing reports, where appropriate, would (1) assist government contracting officers in negotiating proposals and in consistently resolving defective pricing actions resulting from DCAA reports and (2) help promote correction of the conditions leading to defective pricing.

Although conditions appeared to justify the use of DCAM paras. 10-605.4 a. and b., a number of the defective pricing reports we reviewed did not include the information suggested by these paragraphs.

Some Reports Warranted, But Did Not Include, a Reference to Prior Cost Estimating System Reports

Three of the 16 defective pricing reports we reviewed appeared to warrant the use of DCAM para. 10-605.4 a. We believe the reports should have referred to the prior cost estimating system reports that reported the condition causing the defective pricing. However, no such references were included.

For example, DCAA issued defective pricing reports in April and June 1990 on one contractor recommending price adjustments totaling about \$8.8 million--almost all was related to direct labor and associated indirect costs--and citing the contractor for basing its proposals on a higher engineering skill levels than experience indicated would be required. The cost estimating system report issued in June 1987 cited the contractor for not properly utilizing prior experience to estimate engineering labor hours and skill levels. Therefore, for the two defective pricing reports issued in April and June 1990, both considerations in the guidance were met--the condition causing the defective pricing was serious (about \$3.6 million and \$5.1 million reported in the two 1990 reports) and had been previously reported as a cost-estimating deficiency.

The acting head of this field office agreed that including the information called for by DCAM para. 10-605.4 a. would have been appropriate in the April 1990 defective pricing report because the June 1987 cost estimating system report had identified the condition as being systemic before the certification, in December 1987, of the cost or pricing data covered by the April 1990 report. DCAA officials disagreed the language would have been appropriate in the June 1990 defective pricing report because the condition was identified as systemic in June 1987, after the cost or pricing data covered by the report was certified in February 1987. However, since DCAM para. 10-605.4 a. does not refer to certification date, only whether the estimating report was previously issued, we believe the language in DCAM para. 10-605.4 a. also would have been appropriate for the June 1990 report provided the condition had not been corrected before the June 1990 report was issued.

Some Reports Warranted, But Did Not Include,
An Opinion That Conditions Leading
to The Defective Pricing Were Systemic

Ten of the 16 defective pricing reports we reviewed appeared to warrant an opinion that the conditions causing the defective pricing were systemic. We believe these reports should have included the DCAM 10-605.4 b. statement that the condition was systemic.

For example, five separate defective pricing reports issued in September 1990 on one contractor recommended a total of \$11.9 million in price adjustments to direct labor and associated indirect cost and profit add-ons. Each of these reports cited the contractor for basing proposals on outdated labor-hour history or for not disclosing that the actual rates at which the contractor expended labor hours to complete contract tasks prior to negotiation of the contract were lower than the contractor proposed to the government during contract negotiations. None of these reports expressed an opinion that the condition was systemic, nor did they list other reports citing the same condition.

The head of the field office responsible for these five reports said (1) the conditions were not serious enough to warrant reporting the problems as systemic because the proposals were for projects that represent only a small part of the contractor's overall business and the prices were not generated by the contractor's normal pricing and estimating organization and (2) the problems cited in the reports were not identical, although they were similar. However, in our opinion, defective pricing totaling almost \$11.9 million is serious and acknowledgement that the problems cited in the five separate reports were similar warrants reporting as a systemic condition under DCAM para. 10-605.4 b.

DCAM Guidance Is Unclear

Our review indicated that a primary reason why DCAA reports did not address the systemic nature and causes of defective pricing is that the DCAM is unclear about when and how paras. 10-605.4 a. or b. language should be used. For example, the DCAM does not define the criteria for deciding when para. 10-605.4 a. language is appropriate. DCAA officials from headquarters and three of four field audit offices emphasized that auditors should use their professional judgement to determine what was "serious" enough, how "often" was often

enough, or what circumstances had to exist for a problem to be "systemic."

Some field offices acknowledged that terms such as "seriousness" and "frequency" with which a deficiency occurs are too subjective and should be more clearly defined. One region suggested changing the term from seriousness to significant and using the Defense Federal Acquisition Regulation Supplement Part 215.811 definition of significant to clarify the criteria.

We also found that field officials held different views about how similar the conditions had to be to consider them as the same basic problem. Officials at one field office said only if conditions cited from report to report were identical should the underlying causes be reported using the DCAM language. Officials at two other field offices said that if the condition cited in different reports was similar or basically the same, regardless of the specific details of either the condition or the resulting defective pricing, they would consider this as the same systemic condition to be reported as recommended in DCAM paras. 10-605.4 a. or b. One field office indicated that the degree to which a defective pricing condition needs to be similar or identical to a previously reported condition to warrant use of 10-605.4 needs to be clarified.

The DCAA regions raised, or provided information leading to, a number of other questions related to DCAM paras. 10-605.4 a. and b. which further indicates a need for clarifying them. The questions include the following:

- Is it permissible to report systemic deficiencies without using the specific language suggested in para. 10-605.4 b.?
- Is it permissible to report systemic deficiencies in reports other than defective pricing reports, such as cost estimating system flash reports?
- When is a systemic condition considered to exist? Does the DCAM para. 10-605.4 statement apply to deficiencies existing when the audit report was issued or when the proposal was prepared and the cost or pricing data certified?
- Should a single incident trigger reporting under DCAM para. 10-605.4 a. or b., or should the DCAM include guidance

about whether a certain number of defective pricing reports should be issued on a specific condition before reporting that condition as systemic?

The clarity of DCAM 10-605.4 guidance was also questioned in the DOD Inspector General's (IG) recent report Contract Audit Followup Review: Systemic Contract Audit Issues (AFU 93-01, Mar. 16, 1993). The DOD/IG recommended that you issue guidance clarifying that the language in DCAM para. 10-605.4 b. applies to postaward audits of subcontractors and prime contractors' add-on defective pricing audit reports that incorporate or reference assist audits with systemic defective pricing issues.

CONCLUSION

Our work indicates that the DCAM is not clear about when paras. 10-605.4 a. and b. should be used. We believe that, as a result, the information called for by DCAM paras. 10-605.4 a. and b. is not being included in all defective pricing reports that warrant such language. This raises a question of whether DCAA has taken full advantage of an opportunity to highlight the systemic nature and causes of defective pricing.

RECOMMENDATION

We recommend that you revise the DCAM to clarify when and how paras. 10.605 a. and b. should be used to help identify systemic, chronic and recurring problems causing defective pricing.

SCOPE AND METHODOLOGY

Our observations are based on an initial analysis of the conditions that led to subcontract or other material defective pricing cited in 129 reports--of 180 randomly selected during a recent review of defective pricing--that cited subcontract or material defective pricing. Nine of the 129 reports addressed the cause of the defective pricing. We matched the 120 defective pricing reports that did not address the cause of the defective pricing against a file of 173 cost-estimating system reports we had developed from 2 prior reviews, to identify those where we also had cost estimating system reports describing the conditions cited as the cause of defective pricing reported.

We found 16 defective pricing reports and 11 cost-estimating system reports that appeared to involve the same deficiencies. We used these reports in our analysis of whether the DCAM para. 10-605.4 a. guidance was followed.

To determine if the DCAM para. 10-605.4 b. guidance was followed, we first searched our sample of 180 defective pricing reports to identify field offices that had issued three or more reports on the same contractor. We then reviewed the 16 reports issued by 5 of these field offices.

The 180 defective pricing and 173 cost estimating system reports used to develop this correspondence were issued by DCAA between June 1987 and August 1991, and were the subject of our previous reviews. We did not have a complete file of cost estimating and defective pricing reports during the period studied. We limited the scope of this review to the reports we collected previously because our intention was to make you aware of this situation, not to determine the full extent of the problem.

In addition to reviewing the evidence presented in the reports, we contacted officials at four field audit offices to obtain additional information on the circumstances of individual cases and the officials' views on the appropriateness of including the information suggested in DCAM paras. 10-605.4 a. or b. in defective pricing reports. We also obtained their interpretations of this guidance and the factors they considered when deciding if the guidance applied to a specific case. We discussed the DCAM guidance with the DCAA headquarters' defective pricing program manager.

We performed our work from October 1992 to April 1993 in accordance with generally accepted government auditing standards. We did not obtain DOD comments on this correspondence. However, we discussed it with DCAA program officials. In that discussion, DCAA officials also provided comments from DCAA's five regional offices. We revised this letter based on those comments.

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We would appreciate being informed of any action you intend to take to address the issues discussed in this correspondence.

B-242859

Please contact me at (202) 512-7683 if you or your staff have any questions concerning this correspondence. The major contributors to this correspondence 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 "M".

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

CRITERIA FOR DETERMINING SIGNIFICANCE OF CONDITIONS CAUSING
DEFECTIVE PRICING

We evaluated whether the use of DCAM para. 10-605.4 a. language would have been appropriate in defective pricing reports using the following criteria:

- A. The Cost Estimating System (CES) report(s) designated the deficiency as an area of emphasis for government contracting officials in obtaining corrective action and/or negotiating price proposals,
- B. The condition(s) identified in the CES report(s) appeared to have an overall impact on estimates for a major cost element (i.e. all labor costs) of proposals,
- C. The condition or deficiency was identified in the CES report(s) as a "significant" or "major" deficiency, or contributing to "major" cost overstatements,
- D. The condition was identified in the CES report(s) as a recurring deficiency and/or was identified in successive CES reports,
- E. The recommended price adjustment resulting from the condition(s) cited in a defective pricing report was significant. Generally, recommended price adjustments of \$5 million or more were considered as "significant"; where several defective pricing reports cited the same condition or the criteria at A. or B. above was satisfied, the \$5 million was relaxed to include lower dollar amounts (over \$500,000).

Where the condition met any of the criteria at A., B., C., or D. above, and also met the criteria at E. above, we considered it to be serious.

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