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Report to Congressional Committees

February 2001

CONTRACT MANAGEMENT

No DOD Proposal to Improve Contract Service Costs Reporting

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United States General Accounting Office
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Congressional Committees

The Department of Defense (DOD) spends tens of billions of dollars annually on contract services—ranging from services for repairing and maintaining equipment; to services for medical care; to advisory and assistance services such as providing management and technical support, performing studies, and providing technical assistance. In fiscal year 1999, DOD reportedly spent $96.5 billion for contract services—more than it spent on supplies and equipment. Nevertheless, there have been longstanding concerns regarding the accuracy and reliability of DOD's reporting on the costs related to contract services—particularly that expenditures were being improperly justified and classified and accounting systems used to track expenditures were inadequate.[1] In view of these concerns, the Congress requires us to provide an annual assessment of DOD actions to address reporting problems.

To meet the terms of this mandate, in October 1999, we reported[2] that DOD officials could not ensure the accuracy of the classification of contract services costs because of inconsistencies in reporting by the military services, despite issuing new reporting guidance to properly identify these services. In June 1999, DOD concluded in its report to the Congress[3] that its system for reporting contract services had not been successful and must be improved. DOD stated that it would submit a proposal to revise the reporting system. Our objective for this report was to determine DOD's progress in developing this proposal.

[1] Contract services are those provided by contractors to assist program offices in a variety of ways and to maintain equipment and facilities. There are eight categories of contract services, including advisory and assistance services, which are services to support policy development, decision-making, or program management. Appendix I provides a description of the categories for contract services.

[2] *Contract Management: DOD Begins New Effort to Improve Reporting of Contract Service Costs* (GAO/NSIAD-00-29, Oct. 13, 1999).

[3] *Report to Congress on Improved Accounting for Defense Contract Services*, June 1999.

Results in Brief

DOD has not developed a proposal to revise and improve the accuracy of the reporting of contract service costs. DOD officials told us that various internal options were under consideration, however, these officials did not provide any details on these options. DOD officials further stated that the momentum to develop a proposal to improve the reporting of contract services costs had subsided. Without improving this situation, DOD's report on the costs of contract services will still be inaccurate and likely understate what DOD is paying for certain types of services.

We include a recommendation in this report that is intended to accelerate the development of a proposal to improve the accuracy of the reporting of contract service costs.

Background

Reliable information is a critical element in any decision-making process. Accurately capturing the full cost of DOD programs remains one of the most significant challenges DOD faces. We have previously reported[4] that congressional decision-making is hampered by the inadequate, inaccurate information that DOD provides on expenditures associated with support service contracts. Without reliable information, the Congress is limited in using the information reported in the President's budget as it drafts and passes laws that affect spending. Appendix II expands on our past findings.

Table 1 reflects how DOD reports costs related to contract services. Such reporting is done using the object class structure provided in the Office of Management and Budget Circular A-11.[5]

[4] *Defense Advisory and Assistance Service (A&AS) Contracts* (GAO/NSIAD-97-166R, June 13,1997); *DOD Consulting Services: Erroneous Accounting and Reporting of Costs* (GAO/NSIAD-98-136, May 18, 1998); and *Contract Management: DOD Begins New Effort to Improve Reporting of Contract Service Costs* (GAO/NSIAD-00-29, Oct. 13, 1999).

[5] There are five major groupings of object classes in the circular: (1) personnel compensation and benefits, (2) contractual services and supplies, (3) acquisition of assets, (4) grants and fixed charges, and (5) other. Defense contract services, as defined in the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, are a subset of the "contractual services and supplies" category. Specifically, contract services are those contracts included in the "other contractual services"—object class 25. The circular refers to "obligations"—both planned and actual—which are the amounts of orders placed, contracts awarded, services received, and similar actions requiring payments. For simplicity, we have used "costs" throughout the remainder of this report.

Table 1: DOD's Reporting for Contract Services for Fiscal Years 1998-2000

(Dollars in billions)

	Fiscal year		
Object classification	**(Actual)1998**	**(Actual) 1999**	**(Estimated) 2000**
Advisory and assistance	$3.2	$2.5	$2.3
Various[a]	17.1	21.5	21.6
Miscellaneous[b]	15.4	13.5	10.2
Research and Development	27.9	29.5	30.2
Interagency transactions[c]	26.9	29.5	29.4
Total	**$90.6**	**$96.5**	**$93.8**

[a]This covers four service categories: operation and maintenance of facilities, operation and maintenance of equipment, medical care, and subsistence and support of persons.

[b]Includes services that are not classified within one of the other contract service categories.

[c]Purchases from other government agencies.

Source: DOD, Office of the Comptroller.

Over the last several years, we reported that expenditures for certain services were being improperly classified. Specifically, while the President's budget had reported DOD expenditures of $3 billion for advisory and assistance services, we had identified $12 billion of DOD's reported expenditures that could be considered as advisory and assistance.[6] In 1998, we reviewed individual contract actions at one Army command and found that 16 of 21 actions reviewed were erroneously classified as "other" or "miscellaneous" when advisory and assistance services was a more appropriate classification code.[7] We also reported that, overall, too many expenditures were being classified as miscellaneous. Specifically, $47 billion of the $96 billion spent—almost 50 percent—was reported under the miscellaneous classification. Previous DOD reports also found that, with more accurate and reliable reporting of advisory and assistance service expenditures, billions more dollars could be reported to the Congress. In response to these findings, DOD officials stated that there is little incentive for accurate reporting of service costs due to past congressional funding cuts in this area.

[6] *Defense Advisory and Assistance Service Contracts* (GAO/NSIAD-97-166R, June 13, 1997).

[7] *DOD Consulting Services: Erroneous Accounting and Reporting of Costs* (GAO/NSIAD-98-136, May 18, 1998).

To gain better visibility over contract service costs, the Congress imposed a statutory limit in fiscal year 1999 on the percentage of total contract service costs that may be reported as miscellaneous.[8] For fiscal year 2000, the limit was set at 30 percent of total contract service costs and for 2001 (and thereafter) the limit was set at 15 percent. The Congress also required DOD to review and report annually on its proposed budget submission to ensure that contract services are properly classified.

In October 1999, we reported[9] that DOD had taken steps to reduce the amount of expenditures being classified as miscellaneous. For fiscal year 1999, for example, only $13.5 billion was reported in this category. For fiscal year 2000, DOD estimates that $10.2 billion—about 11 percent of the total—will be classified as miscellaneous. However, we also reported that more needed to be done to improve contract service reporting and that DOD officials themselves stated that they could not ensure the accuracy of the classification of contract service costs because of inconsistencies in reporting by the military services. The officials expressed concern about the difficulty in distinguishing between advisory and assistance services and other contract service costs. At the time, DOD stated in its report to the Congress that it planned to take further action to improve the accuracy of contract service reporting.

No New Effort to Develop Proposal to Improve Reporting for Contract Services

DOD has not developed a proposal to improve the accuracy of costs reported for contract services. DOD and military service officials recognize that, without doing so, the Department's reporting will continue to contain some errors and inconsistencies. Even though considerably less expenditures are being classified as miscellaneous, DOD officials stated that the current reporting system will probably continue to be inaccurate due to difficulty in identifying and valuing the services provided by contractors.[10]

[8] Section 911, Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 (P.L. 105-261, Oct.17, 1998).

[9] *Contract Management: DOD Begins New Effort to Improve Reporting of Contract Service Costs* (GAO/NSIAD-00-29, Oct. 13, 1999).

[10] For a description of the variety of services provided by contractors in fiscal year 1999, see *Contract Management: Selected Consulting Services* (GAO/NSIAD-00-183R, June 2, 2000).

Specifically, DOD officials stated that they could not ensure the accuracy of the accounting for contract service costs because of inconsistencies in reporting by the military services as well as the interpretation of broad definitions and other concerns documented in the past. In DOD's 2000 report to the Congress, for example, the military services inconsistently reported data pertaining to intelligence programs:

- The Army interpreted the directive[11] as excluding all advisory and assistance services for intelligence programs and did not include any of the costs for these services.
- The Navy reported in fiscal year 1999, a cost of $4.5 million for intelligence programs, but stated that after taking another look at the directive for this year (2001), it will exclude reporting these services.
- Based on its interpretation of the same DOD directive, the Air Force reported $42.2 million for some intelligence programs such as warfare studies to support air intelligence programs. However, it did not report $44.7 million for advisory and assistance services for other intelligence programs that it believed were exempt from being reported. (App. III contains a description of the exemptions listed in the DOD directive.)

In its June 1999 report, DOD proposed changing the reporting structure for contract services by revising the object class categories found in the Office of Management and Budget Circular A-11. Specifically, DOD suggested that the reporting structure be revised to identify what a specific contract service supports (e.g., weapon systems), rather than identifying what the service is (such as advisory and assistance services' analyses or evaluations). According to DOD and service officials, this revised structure would provide greater visibility on what the contract service was for and where the impact of a funding cut would occur. DOD offered to work with the various interested congressional committees and the Office of Management and Budget on this effort, with the objective of improving the relevance of the data for both the Congress and the executive branch. DOD, however, did not report on its proposal to revise the object class structure in its October 2000 report to the Congress. DOD officials told us that various internal options were under consideration, however, these officials did not provide any details on these various options.

[11] Refers to the Department of Defense Directive 4205.2, captioned "Acquiring and Managing Contracted Advisory and Assistance Services (CAAS)" and issued by the Under Secretary of Defense for Acquisition and Technology on February 10, 1992.

Conclusions

DOD has not developed a proposal to improve the accuracy of the reporting of contract service costs. Without accurate and reliable information, the Congress cannot effectively use the information reported for DOD in the President's budget as it drafts and passes laws that affect spending. Last year, DOD agreed to develop a proposal to resolve this problem. But recently, we were told that DOD's momentum to develop a written proposal had subsided.

Recommendation for Executive Action

We recommend that the Secretary of Defense take immediate action to improve the accuracy of contract service costs reporting. Such action should include

- assigning responsibility for working with the Office of Management and Budget in developing an action plan,
- establishing time frames for completing the action plan, and
- assigning responsibility for implementing the plan.

Agency Comments

DOD reviewed a draft of this report and provided oral comments. The Director of Defense Procurement partly concurred with our recommendation, which was intended to accelerate the development of a proposal to improve the accuracy of the reporting of contract service costs. DOD expressed a desire to work with the various interested congressional committees and the Office of Management and Budget to review and revise the object class categories found in Circular A-11, with the objective of improving the relevance of the data for both the Congress and the executive branch.

DOD stated that references in this report to contract support services generally should be changed to advisory and assistance services. We disagree because in fiscal year 1999, DOD reportedly spent $96.5 billion for contract services—which was substantially more than the $2.3 billion for advisory and assistance services. We believe that to focus on such a small portion of the total would not fully improve the accuracy of reporting of contract service costs.

DOD stated that the title of this report is technically incorrect and recommended that the title be changed to *Update to DOD's Efforts on Reporting on Advisory and Assistance Service Costs*. We believe that the

title, *No DOD Proposal to Improve Contract Service Costs Reporting*, more accurately reflects DOD actions to address reporting problems.

DOD stated that it prepared its fiscal year 2000 report to the Congress in accordance with the guidance and structure provided in Circular A-11. According to DOD, an analysis using DD-350 system data, which feeds into the Federal Procurement System, may produce conclusions significantly different from those arrived at using the A-11 approach, but these two systems are intended for two different purposes and governed by different rules and procedures. DOD stated that such differences in results should not be cited as evidence of the inaccuracy of its report. We believe that the action plan should recognize and address the differences between these two systems.

DOD stated that the problem discussed in the report—ambiguities in the current A-11 guidance—is governmentwide. It stated that it would support and welcome the Office of Management and Budget taking the initiative to bring together government agencies that heavily rely on contract services to address the real and perceived problems inherent in the current reporting process. DOD stated that DOD assignments of responsibility for such an effort will be made when the Office of Management and Budget initiates the project.

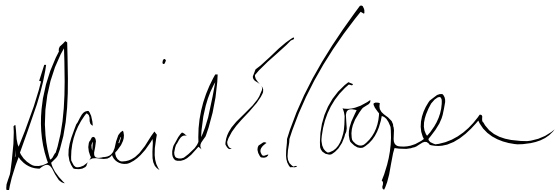
Scope and Methodology

To identify actions taken to improve reporting for contract service costs, we interviewed officials from the Office of the Secretary of Defense Comptroller's office and selected DOD and service components that were responsible for managing and reporting on contract services. We obtained and analyzed information regarding the methodology used to develop the October 2000 report, *Report to Congress on DOD Contract Advisory and Assistance Services*, including DOD directives and the services' instructions for identifying, tracking, and reporting services costs. We also (1) identified differences between current and prior year's methodology to identify contract services, (2) compared data in DOD's budget reporting system with data in the services' budget exhibit to the Congress to determine if such costs were consistent with those reported in the June 1999 report to the Congress, and (3) obtained service headquarters views on the process by which the budget data for contract services were developed. We did not independently verify the accuracy of the numbers DOD reported for contract services.

We conducted our work from July 2000 through October 2000 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Honorable Donald H. Rumsfeld, Secretary of Defense; Lieutenant General Henry T. Glisson, Director, Defense Logistics Agency; the Honorable Gregory R. Dahlberg, Acting Secretary of the Army; the Honorable Robert B. Prie, Acting Secretary of the Navy; the Honorable Lawrence J. Delaney, Acting Secretary of the Air Force; and the Honorable Mitchell E. Daniels, Jr., Director, Office of Management and Budget. We will also make copies available to others on request.

GAO contacts and major contributors to this report are listed in appendix IV.



David E. Cooper
Director
Acquisition and Sourcing Management

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Categories for Contract Services

Obligations for goods and services purchased by the Department of Defense (DOD) are reported using the object class structure specified in the Office of Management and Budget Circular A-11. Contract services are included in the "other contractual services" object class—object class 25. There are eight categories included under contract services. A brief summary of each follows:

- Advisory and assistance services—object class 25.1. Services acquired by contract from nonfederal sources (as well as from other units within the federal government) to provide management and professional support; studies, analyses, and evaluations or engineering and technical services.
- Other services (often called miscellaneous services)—object class 25.2. This object class includes contractual services with nonfederal sources not otherwise classified as either advisory and assistance services or any of the other service categories included under object class 25.
- Purchases of goods and services from government accounts—object class 25.3. Purchases from other federal government agencies or accounts that are not otherwise classified. This object class includes rental payments to agencies other than the General Services Administration and interagency agreements for contractual services for the purchase of goods and services. Excludes, among other things, advisory and assistance services.
- Operation and maintenance of facilities—object class 25.4. This object class includes the operation and maintenance of facilities, when done by contract with the private sector or another federal government account.
- Research and development contracts—object class 25.5. This object class includes contracts for conducting basic and applied research and development, but excludes research and development reported as advisory and assistance services or operation and maintenance of research and development facilities.
- Medical care—object class 25.6. Payments made to contractors for medical care.
- Operation and maintenance of equipment—object class 25.7. Operation, maintenance, repair, and storage of equipment done by contract with the private sector or another federal government account. It includes storage and care of vehicles, storage of household goods, and operation and maintenance of information technology systems.
- Subsistence and support of persons—object class 25.8. Contractual services with the public or another federal government account for board, lodging, and care of persons, including prisoners.

The Office of Management and Budget's definition for advisory and assistance services refers to services acquired by contract from nonfederal sources as well as from other units within the federal government. Object class 25.1 consists of three types of services:

- management and professional support services;
- studies, analyses, and evaluations; and
- engineering and technical services.

Each type of service is described in further detail, including applicable exclusions.

Exclusions for advisory and assistance services include

- information technology consulting services, which have large-scale systems acquisition and integration or large-scale software development as their primary focus and are classified in object class 31.0, Equipment;
- personnel appointments and advisory committees, which are classified in object class 11.3, Other than full-time permanent;
- contracts with the private sector for operation and maintenance of information technology and telecommunication services, which are classified in object class 25.7, Operation and maintenance of equipment;
- architectural and engineering services as defined in the Federal Acquisition Regulation (FAR) 36.102 (40 U.S.C. 541);
- research on theoretical mathematics and basic medical, biological, physical, social, psychological, or other phenomena, which are classified in object class 25.5, Research and development contracts; and
- other contractual services classified in object class 25.2, Other services, through 25.8 Subsistence and support of persons, and 26.0, Supplies and materials.

Management and professional support services are those that assist, advise, or train staff to achieve efficient and effective management and operation of organizations, activities, or systems (including management and professional support services for information technology and research and development activities). They are also those that are normally closely related to the basic responsibilities and mission of the agency contracting for the services and support or contribute to improved organization of program management, project monitoring and reporting, data collection, budgeting, accounting, performance auditing, and administrative/technical support for conference and training programs.

Auditing of financial statements are excluded and are classified in object class 25.2, Other services.

Studies, analyses, and evaluations are those that provide organized analytic assessments or evaluations in support of policy development, decision-making, management or administration. These types of services include studies in support of information technology and research and development activities and models, methodologies, and related software supporting studies, analyses, or evaluations.

Engineering and technical services (excluding routine engineering services and operation maintenance of information technology and data communication services) are those that:

- Support the program office during the acquisition cycle by providing such services as information technology architecture development, systems engineering, and technical direction (FAR 9.505-1(b)).
- Ensure the effective acquisition, operation, and maintenance of a major acquisition, weapon system, or major weapon system as defined in the Office of Management and Budget Circular A-109 and in this circular's supplement, Capital Programming Guide.
- Provide direct support of a major acquisition or weapon system that is essential to planning, research and development, production, or maintenance of the acquisition or system.
- Include information technology consulting services, such as information technology architecture design, capital programming, and investment control support.
- Include software services such as implementing a web-based, commercial off-the-shelf software product that is an integral part of a consulting services contract.

The 1999 Defense Authorization Act provided definitions for the three types of advisory and assistance services. Further, the act provided that those services authorized to be exempted from reporting in the advisory and assistance service category are those identified as exemptions in enclosure 3 of DOD Directive 4205.2 entitled "Acquiring and Managing Contract Advisory and Assistance Services," dated February 10, 1992. While many of these exemptions parallel those provided for in the Office of Management and Budget Circular A-11, there are some differences. DOD officials told us that the Department was working to provide consistent guidance in this area.

Selected GAO Reports

Report	Interest	Findings
Defense Advisory and Assistance Service (A&AS) Contracts (GAO/NSIAD-97-166R, June 13, 1997)	Accurate reporting on advisory and assistance services to the Congress; congressional concern stems from the cost and nature of services.	Underreporting may be due to difficulties in identifying services tasks, ambiguous definition, especially research and development.[a]
DOD Consulting Services: Erroneous Accounting and Reporting of Costs (GAO/NSIAD-98-136, May 18, 1998)	Concerns regarding reliability and costs; underreporting of advisory and assistance services and whether the costs of these services may be included in miscellaneous category.	Tendency to report these costs under miscellaneous category to avoid scrutiny and spending limitations that apply to advisory and assistance services. Cites underreporting reasons listed in a 1985 report: unclear terminology and others—finance and accounting systems, flexible interpretation of definitions.
Contract Management: DOD Begins New Effort to Improve Reporting of Contract Service Costs (GAO/NSIAD-00-29, Oct. 13, 1999)	Concern that without accurate and reliable data appropriate oversight may be hampered.	DOD has taken a number of steps intended to improve the accuracy of costs reported for contract services but recognizes more needs to be done. Adjustments were made most within the object class 25; it acknowledges that reporting will continue to have errors. DOD recommended a change[b] to the reporting structure. DOD provided no comments.
Department of Defense: Progress in Financial Management Reform (GAO/T-AIMD/NSIAD-00-163, May 19, 2000)	Capturing the full cost of its programs remains one of the most significant challenges DOD faces.	DOD must perform basic transaction accounting, including properly classifying transactions.
Contract Management: Selected Consulting Services (GAO/NSIAD-00-183R, June 23, 2000)	Identified the nature of 30 contracts for advisory and assistance services and other services.	Multiple tasks, multiple years make it difficult to categorize and identify costs.

[a]DOD disagreed that it had understated the cost of advisory and assistance services. DOD believed that in fiscal year 1996, the advisory and assistance services amounts captured by its contracting action reporting system was about $1 billion below the $3 billion reported to the Congress. DOD believed that the variance was the result of legitimate differences in reporting criteria.

[b]DOD recommended a change in the reporting structure for reporting contract services. It recommended revising the object class categories found in the Office of Management and Budget Circular A-11 to identify the specific program that the contract services support.

Description of Exemptions for Reporting of Advisory and Assistance Services

Exemptions

Section 911 of the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 states that there are certain authorized exemptions to reporting advisory and assistance services. Specifically, the act states that:

"the term 'authorized exemption' means those exemptions authorized (as of the date of the enactment of this section) under Department of Defense Directive 4205.2, captioned 'Acquiring and Managing Contracted Advisory and Assistance Services (CAAS)' and issued by the Under Secretary of Defense for Acquisition and Technology on February 10, 1992, such exemptions being set forth in Enclosure 3 to that directive (captioned 'CAAS Exemptions')."

The exemptions referred to in enclosure 3

- activities that are reviewed and/or acquired in accordance with the Office of Management and Budget Circular A-76;
- architectural and engineering services for construction and construction management services procured in accordance with FAR Part 36;
- day-to-day operation of facilities and housekeeping services and functions;
- routine maintenance of systems, equipment, and software; routine administrative services; printing services; and direct advertising (media) services;
- initial training services acquired as an integral part of the procurement of weapon systems, automated data processing systems, equipment or components, and training obtained for individual professional development;
- basic operation and management contracts for government-owned, contractor-operated facilities;
- clinical and medical services for direct health care;
- certain automated data processing and/or telecommunication functions and related services controlled in accordance with the Federal Information Resources Management Regulation;
- certain automated data processing and/or telecommunications functions and related services exempted from the Federal Information Resources Management Regulation;
- services supporting the policy development, management, and administration of the Foreign Military Sales Program that are not paid for with funds appropriated by the Congress;
- services (e.g., systems engineering and technical services) acquired by or for a program office to increase the design performance capabilities of existing or new systems or services that are integral to the logistics

support and maintenance of a system or major component and/or end item of equipment essential to the operation of the systems before final government acceptance of a complete hardware system;
- research on theoretical mathematics and basic medical, biological, physical, social, psychological, or other phenomena;
- auctioneers, realty brokers, appraisers, and surveyors; and
- services procured with funds from the Defense Environmental Restoration Account.

Enclosure 3 of the directive does not list intelligence activities among the types of services or activities exempted from the directive.

Section 2 (Applicability and Scope) of the directive (not enclosure 3) states that the directive does not apply to the National Foreign Intelligence Program, the General Defense Intelligence Program, Tactical Intelligence and Related Activities, and programs managed by the Director, National Security Agency/Central Security Service.

GAO Contact and Staff Acknowledgments

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