

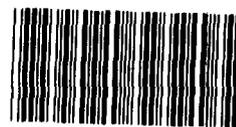
GAO

Fact Sheet for the Chairman, Committee  
on Governmental Affairs, U.S. Senate

May 1992

# CONTRACT PRICING

## Status of Defective Pricing



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**National Security and  
International Affairs Division**

B-248401

May 21, 1992

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

Dear Mr. Chairman:

This report is one in a series being issued in response to your request that we evaluate the adequacy of controls for preventing fraud, waste, and mismanagement in Department of Defense (DOD) subcontract pricing. As agreed with your staff, we analyzed the Defense Contract Audit Agency (DCAA) data base of defective pricing audits to assess whether prime contractors and subcontractors complied with a key safeguard intended to ensure fair and reasonable prices on noncompetitive procurements—the Truth in Negotiations Act (P.L. 87-653, codified at 10 U.S.C. 2306a).<sup>1</sup> Last year, we issued a report analyzing this data base for fiscal years 1987-90.<sup>2</sup>

In this report, we have updated the information to include fiscal year 1991 and have conducted additional analyses of the data. Our objectives were to determine (1) the dollar amount of the potential<sup>3</sup> defective pricing DCAA identified in prime contract and subcontract audits, (2) the risk of defective pricing in smaller contracts, (3) the frequency with which defective pricing occurred in prime contract and subcontract audits, and (4) the extent that defective pricing is concentrated among a small number of contractors.

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**Results in Brief**

During fiscal years 1987-91, DCAA identified defective pricing totaling \$3.67 billion. Defective pricing increased annually until 1990, when it reached \$896.6 million. In fiscal year 1991, defective pricing declined to \$730.7 million.

A significant portion of the defective pricing identified by DCAA is related to subcontracts. While subcontracts accounted for only 16.2 percent of the

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<sup>1</sup>Defective pricing occurs when a contractor or subcontractor negotiating a price for a noncompetitive contract or subcontract, respectively, does not submit accurate, current, or complete data about the costs included in its proposal and, as a result, the contract or subcontract is increased. If defective pricing is found, the government has a right to recover the amount of the overcharge.

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

<sup>3</sup>These are "potential" defective pricing amounts that are based on recommended adjustments to contract prices resulting from DCAA defective pricing audits.

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total dollars DCAA examined in fiscal years 1987-91, subcontract defective pricing accounted for 37.1 percent of the total defective pricing found by DCAA during that period. In fiscal year 1991, subcontract defective pricing rose to \$484 million—accounting for 66.2 percent of the defective pricing reported by DCAA. However, \$346.3 million—over 47 percent—of the 1991 defective pricing reported by DCAA was associated with only 4 of DCAA's 165 fiscal year 1991 subcontract audits with defective pricing findings. This is uncharacteristic of the pattern in previous years. (See app. I.)

Small contracts continue to present a significant risk of defective pricing. DCAA's data shows that the smaller the contract value examined, the higher the percentage of defective pricing. For example, when defective pricing was found in subcontract audits of \$100 million or more, the amount of defective pricing averaged 2.9 percent of subcontract value, but when defective pricing was found in subcontract audits of less than \$10 million, it averaged 11.2 percent of the value examined.

In contrast to the amount of defective pricing, which generally rose during fiscal years 1987-91, the frequency with which DCAA identified defective pricing has declined steadily. In 1987, 48.9 percent of prime contract audits disclosed defective pricing; in 1991 this percentage declined to 21.1 percent. Subcontract defective pricing frequency also declined from 50.1 percent in 1987 to 22.6 percent in 1991. For the 5-year period (1987-91), subcontract audits showed a slightly higher defective pricing frequency rate than did prime contract audits.

Defective pricing is a more significant problem for a relatively small number of contractors. For the 5-year period, about 6 percent of the contractors accounted for about 80 percent of the defective pricing dollar amount DCAA reported. In 1991, less than 3 percent of the contractors accounted for 80 percent of the defective pricing DCAA reported.

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## Background

Contracts exceeding a total of \$443 billion have been examined by DCAA for defective pricing during fiscal years 1987-91. Considering the dollar magnitude of these contracts, the estimates included in contractor proposals are critical elements in establishing the reasonableness of contract prices. Because there is only one possible supplier for many of DOD's needs, they are noncompetitively contracted. Prices for noncompetitive contracts are generally determined through extensive negotiations.

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Recognizing the government's vulnerability in noncompetitive contracting situations, the Congress passed the Truth in Negotiations Act in 1962 to protect the government against overstated contract prices. The act requires that prime contractors and subcontractors submit cost or pricing data supporting their proposed prices above certain thresholds and certify that the data submitted is accurate, complete, and current.

If contractors provide inaccurate, incomplete, or noncurrent data that causes the contract price to be overstated, the act provides the government the right to reduce the contract price. Historically, DOD has successfully recovered about half of the contract price adjustments recommended by DCAA.

DOD established DCAA for the purpose of performing all its contract audits, including defective pricing audits. DCAA performs these audits through its headquarters, 5 regional offices,<sup>4</sup> a field detachment in charge of classified work, and 152 field audit offices. DCAA headquarters develops policy and guidance. Regional offices and the field detachment provide planning and oversight. The field audit offices implement the defective pricing program.

DCAA maintains an automated information system that contains information on completed audits. We used DCAA's data base of completed defective pricing audits as the basis for our analysis.

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## Defective Pricing Totaled \$3.67 Billion

Between fiscal years 1987 and 1991, DCAA completed 8,566 prime contract audits—3,048 (36 percent) identified \$2.31 billion in prime contract defective pricing. DCAA completed 2,795 subcontract defective pricing audits during the 5-year period and 1,053 (38 percent) identified \$1.36 billion in subcontract defective pricing. Overall, for both prime contract and subcontract audits, defective pricing totaled \$3.67 billion for the 5-year period.

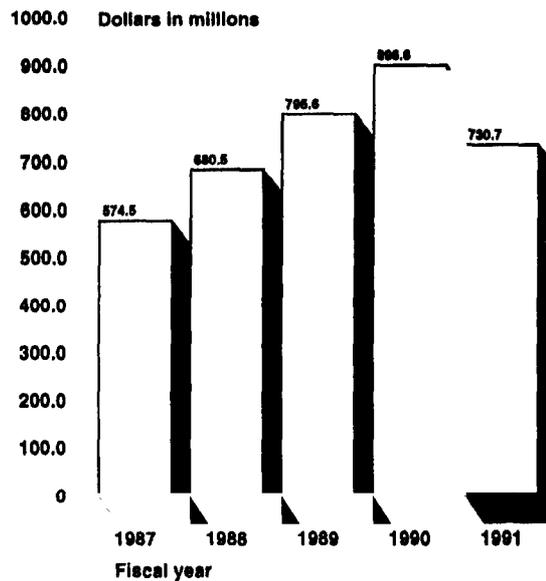
As shown in figure 1, the defective pricing reported by DCAA increased from \$574.5 million in fiscal year 1987 to \$896.6 million in 1990. In fiscal

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<sup>4</sup>Effective October 1991, DCAA realigned its regional structure, reducing the number of regions from six to five.

year 1991, the defective pricing reported by DCAA declined to \$730.7 million.<sup>5</sup> (This amount, as do all the fiscal year 1991 amounts shown in our figures and tables, includes the four “outlier” contracts identified in appendix I. Footnotes show the effect on the statistics in the figures and tables when the four outlier subcontract audits are removed from the calculations.)

**Figure 1: Total Defective Pricing Dollar Trends**



## Subcontract Defective Pricing Continues to Be Costly

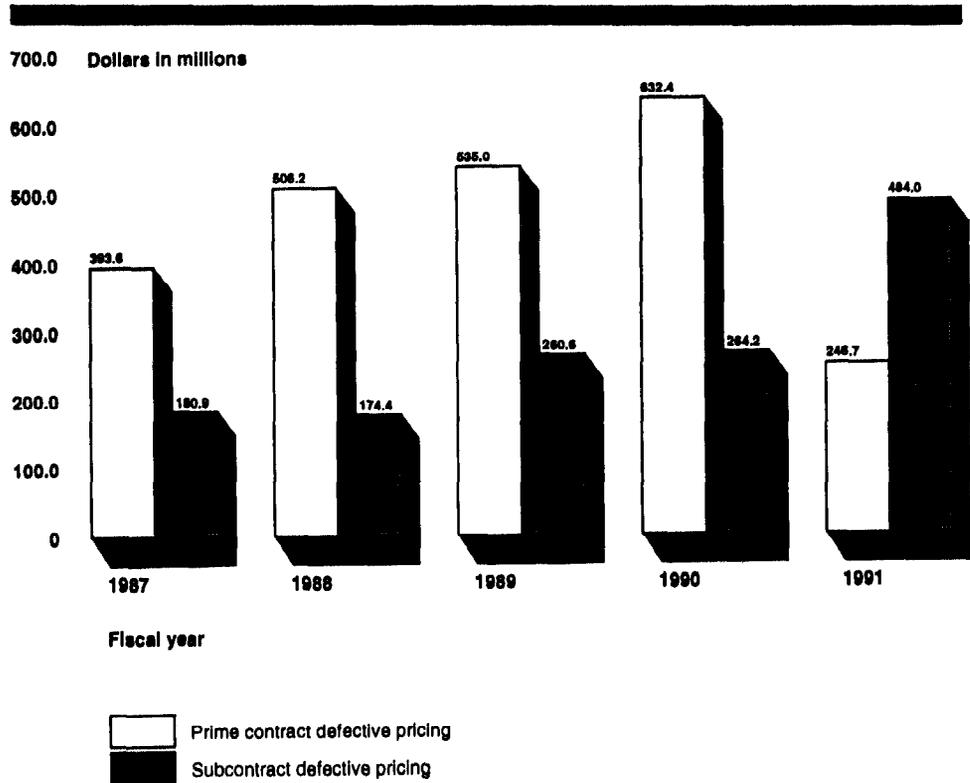
Last year we reported that subcontract defective pricing reported by DCAA had been steadily increasing. This year we found that subcontract defective pricing increased—from \$264.2 million in fiscal year 1990 to \$484 million in fiscal year 1991—accounting for 66.2 percent of the defective pricing found by DCAA.<sup>6</sup> Prime contract defective pricing decreased from

<sup>5</sup>Without the four “outlier” audits, total defective pricing for fiscal year 1991 would have been \$384.4 million.

<sup>6</sup>Without the four outlier audits, subcontract defective pricing for fiscal year 1991 would have been \$137.7 million—a 48-percent decrease from 1990. The outliers are 4 of DCAA’s 165 fiscal year 1991 subcontractor audits with defective pricing findings.

\$632.4 million in fiscal year 1990 to \$246.7 million in fiscal year 1991.  
(See fig. 2.)

**Figure 2: Prime Contract and Subcontract Defective Pricing Dollar Trends**

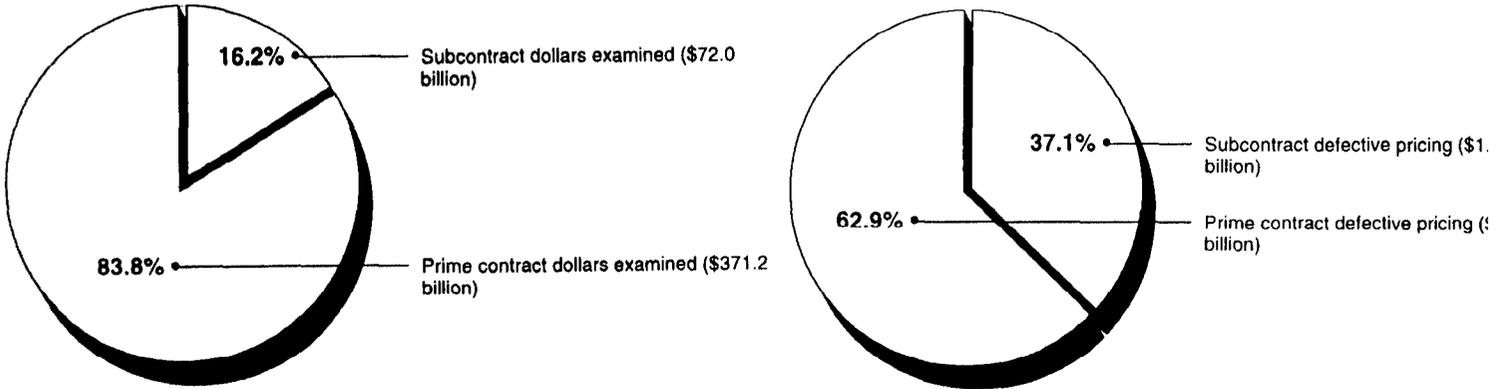


**Subcontract Audits Had a Disproportionate Share of Defective Pricing Dollars**

While subcontract audits accounted for 16.2 percent of all dollars examined by DCAA during the fiscal years 1987-91 (\$72 billion versus \$371.2 billion for prime contracts), subcontract defective pricing accounted for 37.1 percent of all defective pricing reported (\$1.36 billion versus \$2.31 billion for prime contracts).<sup>7</sup> (See fig. 3.)

<sup>7</sup>Without the four outlier audits, subcontract audits accounted for 15.9 percent of all dollars examined (\$70.3 billion versus \$371.2 billion for prime contracts) and 30.6 percent of all defective pricing reported (\$1.02 billion versus \$2.31 billion for prime contracts).

**Figure 3: Total Contract Dollars Examined and Defective Pricing Reported, Fiscal Years 1987-91**



### Defective Pricing in Smaller Contracts

Last year we reported that subcontracts valued at less than \$10 million had, as a percentage of contract value, more defective pricing than did larger subcontracts, indicating that smaller subcontracts presented a significant risk of defective pricing. DCAA's data for fiscal years 1987-91 shows that defective pricing was, on average, 7.1 percent of the total value of prime contract audits under \$10 million and 11.2 percent of the total value of subcontract audits under \$10 million. By comparison, for audits of contracts valued at \$100 million or more, defective pricing was, on average, 0.7 percent of total prime contract value audited and 2.9 percent<sup>8</sup> of the total subcontract value audited. (See table 1.)

<sup>8</sup>Without the four outlier subcontract audits, the average defective pricing as a percent of contract value would have been 1.5 percent.

**Table 1: Defective Pricing as a Percentage of Contract Value for Audits With Findings, Fiscal Years 1987-91**

Contract value audited	Percent of prime contract value	Percent of subcontract value
\$100 million or greater	0.7	2.9
\$25 million to less than \$100 million	2.3	3.8
\$10 million to less than \$25 million	3.4	5.2
\$100,000 to less than \$10 million	7.1	11.2

Furthermore, as shown in table 2, defective pricing as a percentage of dollars examined for audits of contracts under \$10 million also increased as the size of the dollars examined per audit decreased. For audits valued at less than \$500,000, defective pricing reached 24.4 percent of the value of prime contract dollars audited and 24.0 percent of the value of subcontract dollars audited.

**Table 2: Defective Pricing as a Percentage of Contract Value (Under \$10 Million) for Audits With Findings, Fiscal Years 1987-91**

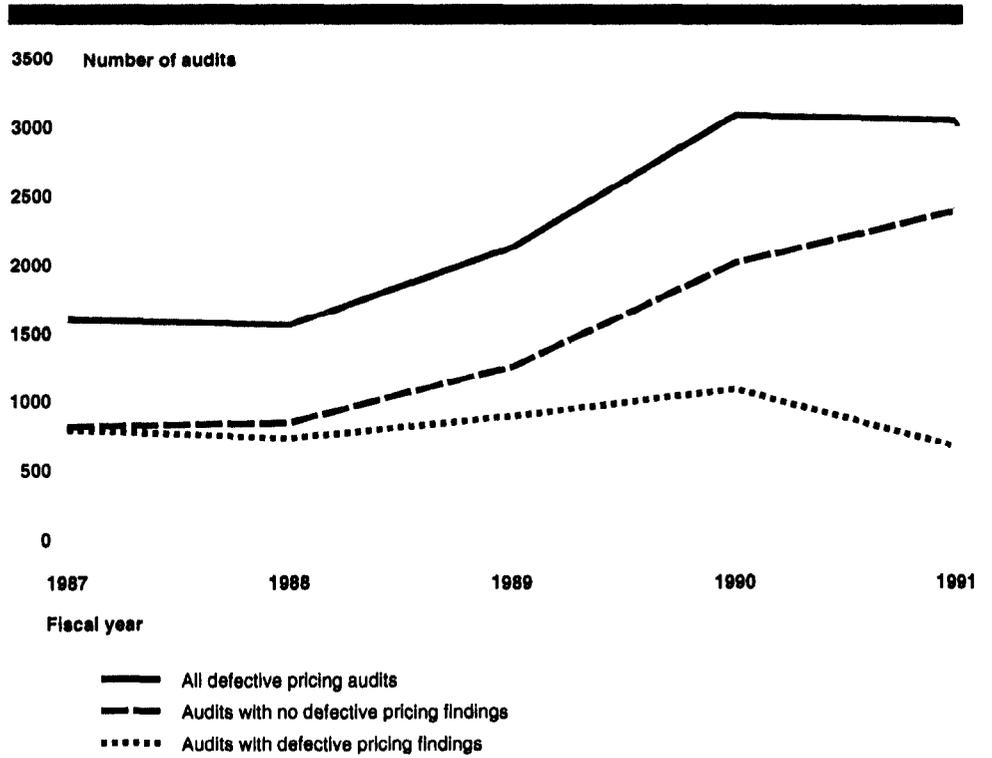
Contract value audited	Percent of prime contract value	Percent of subcontract value
\$5 million to less than \$10 million	4.6	9.6
\$1 million to less than \$5 million	9.7	12.7
\$500,000 to less than \$1 million	17.1	16.2
\$100,000 to less than \$500,000	24.4	24.0

Looking at the smallest dollar stratum in table 2, over the 5-year period, DCAA completed 547 prime contract audits valued under \$500,000 each and found \$14.6 million of defective pricing on 215 of the audits. For the same period, DCAA completed 177 subcontract audits, also valued under \$500,000, and found \$3.9 million of defective pricing on 57 of the audits.

## Frequency of Identified Defective Pricing Has Declined

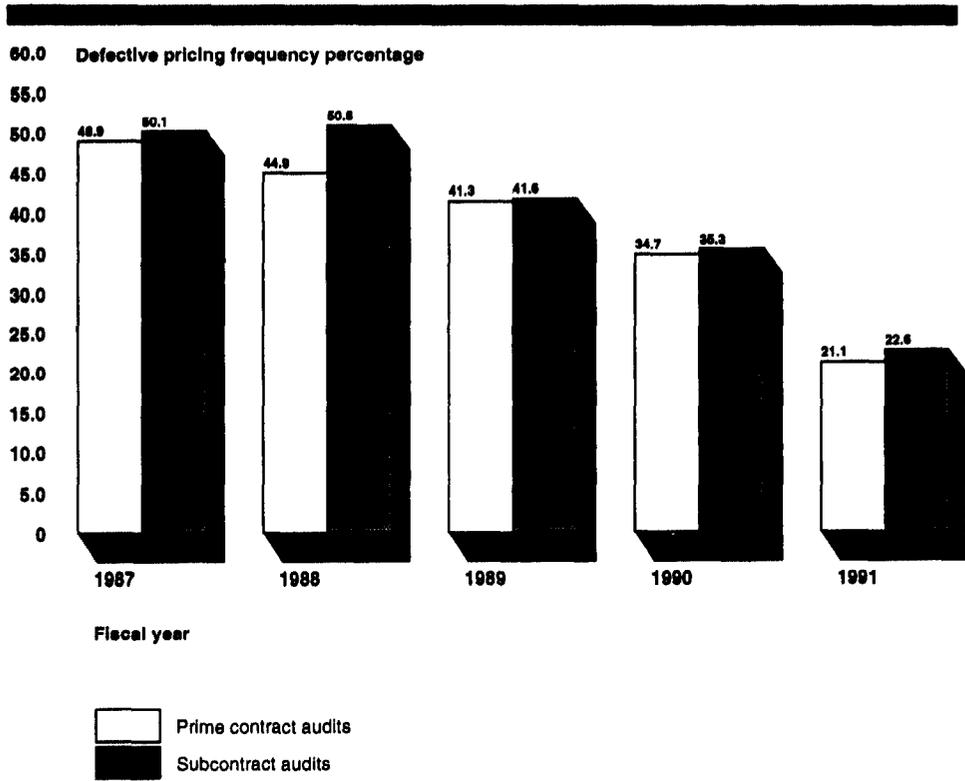
Between fiscal years 1987 and 1991, the frequency with which DCAA audits identified defective pricing has declined. Overall, DCAA increased the total annual number of defective pricing audits from 1,592 in 1987 to 3,028 in 1991 (a 90-percent increase). Of these, the number for which no defective pricing findings were reported increased annually, from 808 audits in 1987 to 2,378 audits in 1991 (a 194-percent increase). By comparison, the number of defective pricing audits with findings increased gradually from 784 in 1987 to 1,070 in 1990 and then declined by 39 percent to 650 in 1991. (See fig. 4.)

**Figure 4: Number of Defective Pricing Audits Completed**



The decreased frequency of identified defective pricing occurred both in prime contracts and in subcontracts. Figure 5 shows that in fiscal year 1987, prime contract defective pricing occurred at a 48.9-percent frequency; in fiscal year 1991, it dropped to 21.1 percent. A similar decline occurred in subcontract defective pricing—from 50.1 percent in 1987 to 22.6 percent in 1991. Also, for the fiscal years 1987-91, subcontract audits showed a slightly higher defective pricing frequency rate than prime contract audits.

**Figure 5: Frequency of Defective Pricing in Prime Contract and Subcontract Audits**



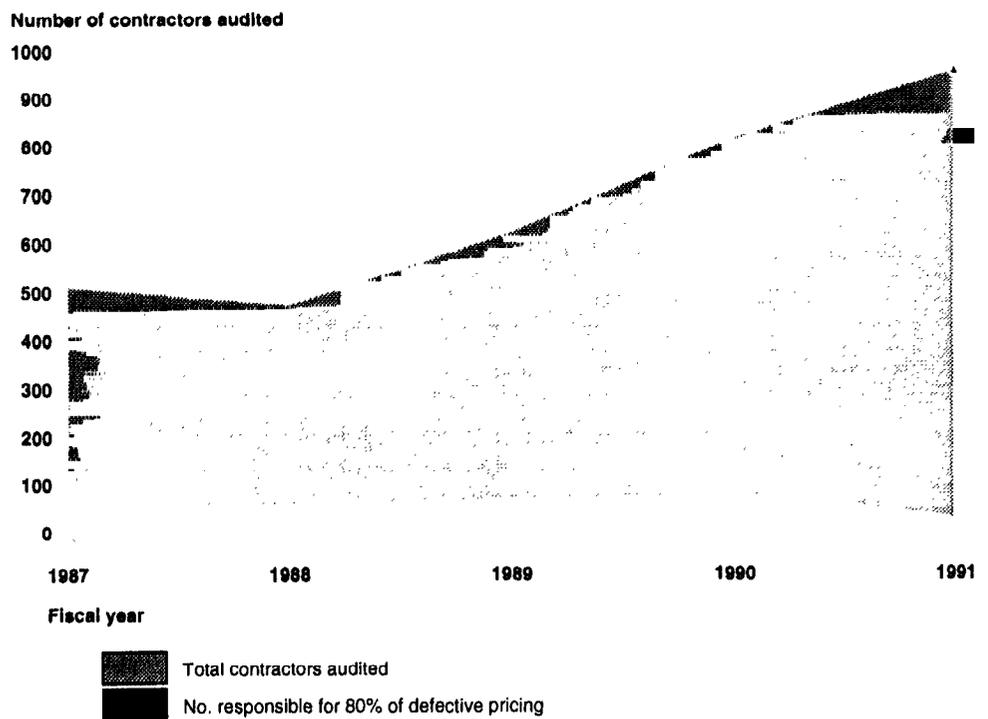
**Reasons for the Decline in the Defective Pricing DCAA Identified in Fiscal Year 1991**

The reasons, in part, for the \$165.9 million decrease in the defective pricing DCAA reported between fiscal years 1990 and 1991 are the changes that occurred (1) in the total dollar value of the contracts DCAA audited and (2) in the frequency with which DCAA found defective pricing. The total dollar value of the contracts DCAA audited for defective pricing declined by 35.3 percent for prime contracts and by 18.5 percent for subcontracts (excluding the four outlier subcontracts). The frequency with which DCAA identified defective pricing in completed prime contract audits declined from 34.7 percent in fiscal year 1990 to 21.1 percent in fiscal year 1991. The frequency with which DCAA identified defective pricing in completed subcontract audits declined from 35.3 percent in fiscal year 1990 to 22.6 percent in fiscal year 1991.

## A Small Number of Contractors Were Responsible for Most of the Defective Pricing

DCAA's audit reports show that defective pricing is a more significant problem for a relatively small number of contractors. For fiscal years 1987-91, about 6 percent of the contractors audited accounted for about 80 percent of the \$3.67 billion in defective pricing identified by DCAA. Further, the percent of contractors accounting for 80 percent of the defective pricing decreased during the 5-year period, from about 11 percent in fiscal year 1987 to less than 3 percent in fiscal year 1991. Between fiscal year 1990 and fiscal year 1991, the number of contractors responsible for 80 percent of the defective pricing dropped from 73 to 26, a decline of 64 percent.<sup>9</sup> By comparison, the total number of contractors audited had risen from 812 to 954. (See fig. 6.)

**Figure 6: Only a Few of the Total Contractors Audited Were Responsible for 80 Percent of Defective Pricing**



The 1991 group of contractors with 80 percent of the defective pricing also shows a degree of consistency with previous years. Of these 26 contractors,

<sup>9</sup>This analysis includes the four subcontract outliers for fiscal year 1991. If they were excluded, the number of contractors responsible for 80 percent of the defective pricing in 1991 would be 53.

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17 were in the group with 80 percent of the defective pricing in at least 1 of the preceding 4 years, and 4 were in this group for all 4 of the previous years.

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## Scope and Methodology

From DCAA's data base of defective pricing audits, we reviewed contracts totaling \$100,000 or more and completed between October 1986 and September 1991. We relied on DCAA's automated information system, which contained information on completed audits. Since we used computer-processed data to support our audit objectives, we evaluated and selectively tested controls over the data. Our testing of the fiscal year 1987-90 data did not identify significant data accuracy problems, although we identified some minor internal control weaknesses. For the fiscal year 1991 data, we identified, through selective testing, a number of input errors in DCAA's data base, which we were able to correct before performing our analyses. As a result of our evaluations, tests, and corrections, we believe the data for the 5-year period is sufficiently usable for our audit efforts.

When we reviewed DCAA's data base, we found that four of the fiscal year 1991 audits contributed \$346.3 million, over 47 percent, of the total defective pricing DCAA reported in fiscal year 1991. The unusual magnitude of the largest four audit findings of fiscal year 1991 is shown in appendix I, which compares these audit findings with the largest four audit findings of the previous fiscal years. Appendix I shows that the four largest findings for 1991, as a percent of total defective pricing for the year, contributed almost 4 times the defective pricing of the top four audits completed by DCAA during any fiscal year from 1987 to 1990.

We reviewed DCAA policy and guidance on defective pricing audits. We also interviewed selected DCAA officials knowledgeable of the data information systems, or responsible for the defective pricing program at DCAA headquarters in Washington, D.C.

As arranged with your office, we did not obtain written agency comments, however, we discussed the report with agency officials. The officials generally agreed with the facts we presented. At their suggestion, we clarified some of the percentages discussed in the report. We conducted our review between November 1991 and March 1992 in accordance with generally accepted government auditing standards.

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Unless you publicly announced 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 Directors of the Defense Logistics Agency and DCAA; the Director, Office of Management and Budget; and interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report 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, Research, Development,  
Acquisition, and Procurement Issues



# Four Largest Defective Pricing Dollar Findings, Per Audit, From DCAA's Defective Pricing Data Base, Fiscal Years 1987-91

Dollars in thousands					
Dollar rank per audit	Defective pricing				
	1987	1988	1989	1990	1991
1st	22,663	26,279	30,398	33,228	104,220 <sup>a</sup>
2nd	19,038	23,386	26,670	32,844	104,068 <sup>a</sup>
3rd	18,318	21,189	22,899	24,199	70,950 <sup>a</sup>
4th	15,419	15,254	21,841	18,419	67,034 <sup>a</sup>
<b>Total, top 4 audits</b>	<b>75,438</b>	<b>86,108</b>	<b>101,808</b>	<b>108,690</b>	<b>346,272</b>
<b>Yearly total, all audits</b>	<b>574,489</b>	<b>680,539</b>	<b>795,600</b>	<b>896,568</b>	<b>730,680</b>
<b>Top 4 as a % of yearly total</b>	<b>13.1%</b>	<b>12.7%</b>	<b>12.8%</b>	<b>12.1%</b>	<b>47.4%</b>

<sup>a</sup>Due to their high amounts of defective pricing, these are the four audits we identified as "outliers." The defective pricing for each of these audits is at least double the amount reported for any other audit during the 5-year period.

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# Major Contributors to This Report

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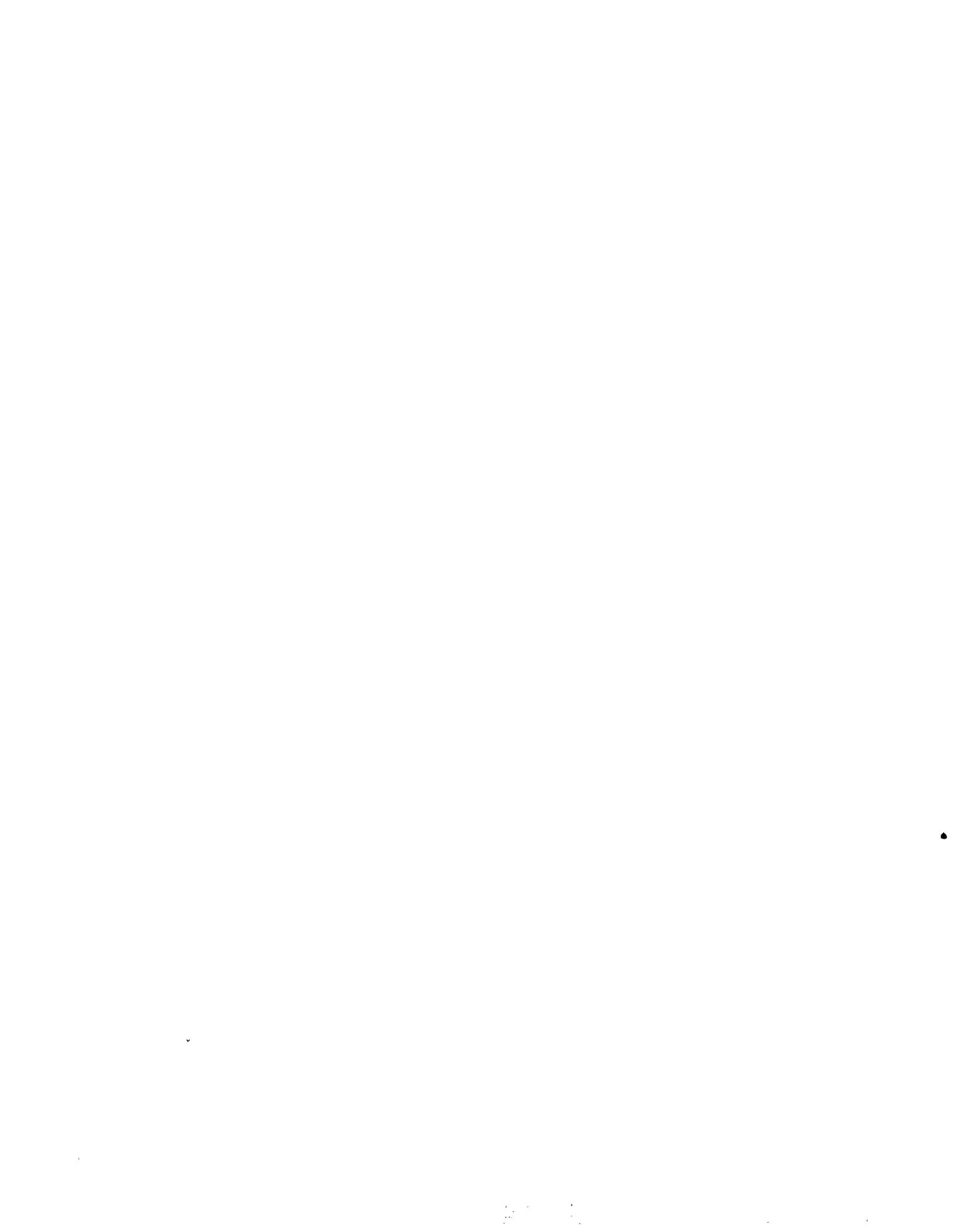
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