

GAO

Report to the Committee on Oversight
and Government Reform, House of
Representatives

September 2009

CONTRACT MANAGEMENT

Extent of Federal
Spending under Cost-
Reimbursement
Contracts Unclear and
Key Controls Not
Always Used



GAO

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Highlights of [GAO-09-921](#), a report to the Committee on Oversight and Government Reform, House of Representatives

Why GAO Did This Study

Federal agencies obligate billions of dollars annually using cost-reimbursement contracts. This type of contract involves high risk for the government because of the potential for cost escalation and because the government pays a contractor's costs of performance regardless of whether the work is completed. As such, cost-reimbursement contracts are suitable only when the cost of the work to be done cannot be estimated with sufficient accuracy to use fixed-price contracts. Agencies may use this contract type only if certain conditions are met. At your request, GAO assessed (1) the extent of agencies' obligations under these contracts, (2) the rationales for using this contract type, (3) determinations that contractors' accounting systems are adequate for determining costs applicable to the contracts, and (4) procedures for monitoring contractor cost controls. GAO analyzed federal procurement data and contract files and interviewed contracting and other government officials.

What GAO Recommends

GAO is making recommendations to the Office of Federal Procurement Policy (OFPP) regarding how contracts are coded in the government's procurement database and aimed at encouraging timely analysis to determine if a transition can be made to a contract with a firmer pricing basis. OFPP agreed with the recommendations. The other agencies in GAO's review generally agreed with the findings in the report or had no comments. [View GAO-09-921](#) or [key components](#). For more information, contact John Needham at (202) 512-4841 or needhamJK1@gao.gov.

CONTRACT MANAGEMENT

Extent of Federal Spending under Cost-Reimbursement Contracts Unclear and Key Controls Not Always Used

What GAO Found

The complete picture of the government's use of cost-reimbursement contracts is unclear. From fiscal years 2003 through 2008 federal obligations under cost-reimbursement contracts were reported to have increased \$16 billion, to \$136 billion, which represented a decrease in the total percentage of federal obligations over the 6-year period, from 34 percent to 26 percent. However, the overall downward trend is misleading. A significant increase has been reported for obligations using the "combination" contract type, a category that based on GAO's analysis of 2008 data, includes many contracts with cost-reimbursement obligations that are not recorded as such. According to OFPP, a decision was recently made to eliminate the use of "combination" as a Federal Procurement Data System-Next Generation contract type, effective for all new contract awards starting in fiscal year 2010. In addition, GAO found billions of dollars for which the contract type had been coded as "missing" in fiscal year 2008.

Agencies' rationales for using cost-reimbursement contracts were difficult to determine because contracting officers frequently did not document—even in acquisition plans—why they chose to use this contract type. The current requirement for such documentation is minimal, but recent legislation (not yet implemented in the Federal Acquisition Regulation) requires that acquisition plans address the rationale. Of the 92 contracts and orders GAO reviewed, about 30 percent did not include any documentation. The supporting documentation GAO did find generally did not explain why a cost-reimbursement contract for the specific requirement was selected. GAO also found little evidence that agency officials are analyzing contracts' pricing history and requirements to determine if they can transition to a contract type with firmer pricing, even though experience may provide a basis for doing so.

Of the 92 contracts and orders GAO reviewed, about half had any evidence that, at least within 4 years before contract award, contractors' accounting systems had been deemed adequate to determine costs applicable to the contract. Twenty contract files had no evidence that the contractors' accounting systems were determined adequate and 20 other contract files contained determinations that had been made either many years before award or after the contract was awarded. Inadequate accounting systems, or accounting systems that had not been deemed adequate for many years, may result in the government making improper payments to contractors.

GAO found a range of procedures for monitoring contractor cost controls at the agencies in its review. Procedures at the civilian agencies generally call for program officials to review contractor invoices. At the Department of Defense, cost surveillance depends on contractor-reported earned value management data, supplemented with audits for the purpose of testing whether invoiced costs are allowable. GAO's prior work has raised concerns about the effectiveness of these audits.

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Abbreviations

AHRQ	Agency for Healthcare Research and Quality
COR	Contracting Officer's Representative
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DOE	Department of Energy
EVM	Earned Value Management
FAR	Federal Acquisition Regulation
FFP	Firm Fixed Price
FPDS-NG	Federal Procurement Data System-Next Generation
GAO	Government Accountability Office
IRS	Internal Revenue Service
IT	Information Technology
NASA	National Aeronautics and Space Administration
NIH	National Institutes of Health
NSF	National Science Foundation
OFPP	Office of Federal Procurement Policy

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United States Government Accountability Office
Washington, DC 20548

September 30, 2009

The Honorable Edolphus Towns
Chairman
The Honorable Darrell Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

Federal agencies obligate more than \$100 billion annually using cost-reimbursement contracts. This type of contract is considered high risk for the government because of the potential for cost escalation and because the government pays a contractor's costs of performance regardless of whether the work is completed. As such, cost-reimbursement contracts are suitable only when the cost of the work to be done cannot be estimated with sufficient accuracy to use any type of fixed-price contract.

To mitigate risk and help ensure that the best interests of the government are served when entering into a cost-reimbursement contract, agencies may use this contract type only if the contractor's accounting system is adequate for determining costs applicable to the contract. This helps prevent situations where contractors bill the government for unallowable costs. Appropriate government surveillance is also required to provide reasonable assurance that the contractor is using efficient methods and effective cost controls. At your request, we reviewed the federal government's use of cost-reimbursement contracts and

- identified agencies' reported obligations under these contracts,
- determined what agencies are buying using cost-reimbursement contracts,
- assessed contracting officers' rationales for using this contract type and whether analysis is being conducted to determine whether a different contract type is warranted based on experience with the requirement,
- determined whether contractors' accounting systems had been deemed adequate for determining costs applicable to the contracts, and
- identified agencies' procedures for surveillance of contractor cost controls.

To select the agencies included in our review, we analyzed cost-reimbursement contract actions and dollars obligated as reported in the

Federal Procurement Data System-Next Generation (FPDS- NG).¹ Fiscal year 2007 FPDS-NG data were the latest available at the time we selected the agencies for review, but we subsequently obtained data on cost-reimbursement obligations for fiscal year 2008 and included those data in our trend analysis. Based on the fiscal year 2007 data, we grouped agencies into one of three categories:

- agencies whose obligations under cost-reimbursement contracts were less than 20 percent,
- agencies whose obligations were from 20 to 50 percent, and
- agencies whose obligations were 51 percent or higher.

We reviewed contract files for 10 randomly selected contracts or orders (orders are used to procure goods or services from an established contract) from each of 10 agencies that fell in the second and third categories, with two exceptions. We reviewed only one contract at the Corporation for National and Community Service and at the Department of the Treasury’s Alcohol and Tobacco Tax and Trade Bureau, as those contracts accounted for the totality of those agencies’ reported cost-reimbursement contracts in fiscal year 2007. In all, we reviewed 92 contracts or orders issued under cost-reimbursement contracts. We tested the reliability of the FPDS-NG data by comparing basic reported information (such as contract number, contract type, and awarding activity) to information in the contract or order files. Table 1 shows the agencies where we conducted the file reviews and the percentages of reported fiscal year 2007 obligations using cost-reimbursement contracts or orders.

Table 1: Agencies Reviewed and Percentages of Cost-Reimbursement Obligations Reported in Fiscal Year 2007

Department/agency	Reported percentage of cost-reimbursement obligations
Department of the Air Force/Aeronautical Systems Center	33
Corporation for National and Community Service	35
Department of the Treasury/Internal Revenue Service	36
Department of the Navy/Navy Strategic Systems Program	39

¹ FPDS-NG contains detailed information on contract actions and identifies, among other data, the contract types used by federal agencies in procuring goods and services.

Department/agency	Reported percentage of cost-reimbursement obligations
Environmental Protection Agency/Cincinnati Procurement Operations Division	45
National Aeronautics and Space Administration/Glenn Research Center	81
National Science Foundation	81
Department of Health and Human Services/Agency for Healthcare Research and Quality	87
Department of Energy	90
Department of Defense/Defense Microelectronics Activity	97
Department of the Treasury/Alcohol and Tobacco Tax and Trade Bureau	100

Source: GAO analysis of FPDS-NG data.

We supplemented our file reviews by interviewing the cognizant contracting officials and personnel responsible for surveillance of contractor costs. We identified surveillance procedures at the agencies in our review but, because of time constraints, did not assess compliance with those procedures for the 92 contracts and orders. In addition, we interviewed agency procurement policy representatives and heads of contracting activities for 10 agencies from the first category cited above, which had reported a very high use (95 percent or more) of fixed-price contracts, to determine the reasons for their low use of cost-reimbursement contracts. We reviewed relevant sections of the Federal Acquisition Regulation (FAR), implementing agency policies and regulations, our *Standards for Internal Control in the Federal Government*,² and past GAO reports. In determining whether the contractors' accounting systems had been deemed adequate before contract award, we used a period of 4 years, which is the outermost time frame in Defense Contract Audit Agency (DCAA) policy, as being "current" for auditing an accounting system that has a significant impact on government contract costs. We sought any evidence in the contract file that the contracting officer had made a determination of the adequacy of a contractor's accounting system and, where there was no evidence, we held discussions with the contracting officer.

² GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](https://www.gao.gov/products/GAO/AIMD-00-21.3.1) (Washington, D.C.: November 1999).

We conducted this performance audit from July 2008 to September 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix I provides more detail on our scope and methodology, as well as a listing of the 10 agencies with reported high use of fixed-price contracts.

Background

Federal agencies can choose among three main contract types to procure goods and services: fixed-price, time-and-materials, and cost-reimbursement. Each contract type comes with a different level of cost or performance risk for the government, as shown in table 2.

Table 2: Contract Types

Government	Contractor	Risk to...
Fixed-price		
Pays fixed price even if actual total cost of product or service falls short of or exceeds the contract price. May also pay an award or incentive fee related to performance.	Provides an acceptable deliverable at the time, place, and price specified in the contract.	Contractor
Time-and-materials		
Pays fixed per-hour labor rates that include wages, overhead, general administrative costs, and profit; government might reimburse contractor for other direct costs, such as travel and materials costs. Contracts include a ceiling price that the contractor exceeds at its own risk. Government is not guaranteed a completed end item or service within the ceiling price.	Makes good faith effort to meet government's needs within the ceiling price.	Government
Cost-reimbursement		
Pays contractor's allowable costs incurred, to the extent prescribed by the contract. Also may pay a fee, which may be related to performance. Contracts include an estimated total cost for purposes of obligating funds and a ceiling that the contractor exceeds at its own risk (unless approved by the contracting officer). Government is not guaranteed a completed end item or service within the estimated cost. The FAR prohibits the use of cost-reimbursement contracts to acquire commercial items.	Makes good faith effort to meet government's needs within the estimated cost.	Government

Source: GAO analysis of the FAR, Defense Federal Acquisition Regulation Supplement, and DOD Contract Pricing Guide.

Different types of cost-reimbursement contracts can be used, based on whether incentives, award fees, or other arrangements can be used to

motivate contractor efforts and discourage contractor inefficiency and waste. Some of these types, and their limitations, follow.³

- **Cost-sharing contracts:** The contractor receives no fee and is reimbursed only for an agreed-upon portion of its allowable costs. A cost-sharing contract may be used when the contractor agrees to absorb a portion of the costs, in the expectation of substantial compensating benefits.
- **Cost-plus-incentive-fee contracts:** An objective relationship can be established between the fee earned and performance results, such as actual costs or delivery dates. This contract type provides for an initially negotiated fee to be adjusted later by a formula based on the relationship of total allowable costs to total target costs.
- **Cost-plus-award-fee contracts:** Objective incentive targets are not feasible and judgmental standards, such as quality and technical ingenuity, can be applied. A potential fee is intended to provide an incentive for excellence in such areas as quality, timeliness, technical ingenuity, and cost effective management; award of the fee is a unilateral decision made solely by the government. We have reported on agencies' use of cost-plus-award-fee contracts, finding in some cases that award fees had been paid to contractors regardless of acquisition outcomes.⁴
- **Cost-plus-fixed-fee contracts:** These contracts provide for payment to the contractor of a negotiated fee that is fixed at contract inception. The fixed fee does not vary with actual cost, but may be adjusted as a result of changes in the work to be performed under the contract. This contract type permits contracting for efforts that might otherwise present too great a risk to contractors, but it provides the contractor only a minimum incentive to control costs. Cost-plus-fixed-fee contracts are suitable, for example, when contracting for research or preliminary exploration or study, and the level of effort required is unknown.

Cost-reimbursement contracts are suitable only when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use a fixed-price contract. The two major reasons for the inability to accurately estimate costs are (1) the lack of knowledge

³ See FAR Subpart 16.3 and Subpart 16.4 for more details on these contract types' descriptions and applications.

⁴ GAO, *Federal Contracting: Guidance on Award Fees Has Led to Better Practices but Is Not Consistently Applied*, [GAO-09-630](#) (Washington, D.C.: May 29, 2009); NASA *Procurement: Use of Award Fees for Achieving Program Outcomes Should Be Improved*, [GAO-07-58](#) (Washington, D.C.: Jan. 17, 2007); and *Defense Acquisitions: DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes*, [GAO-06-66](#) (Washington, D.C.: Dec. 19, 2005).

of the work needed to meet the requirements of the contract, for example, under research contracts, which necessarily involve substantial uncertainties, and (2) the lack of cost experience in performing work, such as the development of a weapon system because manufacturing techniques and specifications are not stable enough to warrant contracting on a fixed-price basis. We have reported that during weapon system development, the Department of Defense (DOD) often asks prime contractors to develop cutting-edge systems and awards cost-reimbursement contracts for the work. Because the government often does not perform the up-front analysis needed to determine whether its needs can be met by the contract requirements, significant cost increases can occur under the contracts as the scope of requirements changes or becomes better understood. As of fiscal year 2007, for example, DOD anticipated reimbursing the prime contractors on the Joint Strike Fighter and Future Combat Systems programs nearly \$13 billion more than initially expected.⁵

Cost-reimbursement contracts involve significantly more government oversight than do fixed-price contracts, which means the government incurs additional administrative costs on top of what it is paying the contractor. For example, the government must determine that the contractor's accounting system is adequate for determining costs related to the contract and update this determination periodically. In addition, contractor costs need to be monitored—known as cost surveillance—to provide reasonable assurance that efficient methods and effective cost controls are used.

Congress has taken action to increase oversight of these contracts, for DOD specifically as well as governmentwide. The John Warner National Defense Authorization Act for Fiscal Year 2007 called for the Secretary of Defense to modify DOD's regulations to require at Milestone B (approval for major acquisition programs to enter the engineering and manufacturing development phase) documentation of the basis for the contract type. Before approving the use of a cost-type contract for development, the Milestone Decision Authority must execute a written determination that among other things, the program is so complex and technically challenging that it would not be practicable to reduce program risk to a level that

⁵ GAO, *Defense Acquisitions: Assessments of Selected Weapon Programs*, [GAO-08-467SP](#) (Washington, D.C.: Mar. 31, 2008).

would permit the use of a fixed-price type contract.⁶ Further, the conference report accompanying the act stated that DOD should reduce program risk to the point that the use of a fixed-price contract for a major acquisition program may be appropriate.

In addition, the Duncan Hunter National Defense Authorization Act for Fiscal Year 2009 called for revisions to the FAR, to include guidance on (1) when and under what circumstances cost-reimbursement contracts are appropriate, (2) the acquisition plan findings necessary to support decisions to use cost-reimbursement contracts, and (3) the acquisition workforce resources necessary to award and manage cost-reimbursement contracts.⁷ The FAR revisions were required by July 11, 2009, but as of September 28, 2009, had not been implemented. This act also states that within 1 year after these revisions are promulgated, the inspector general for each executive agency shall review the use of cost-reimbursement contracts by the agency for compliance with these regulations and must include the results of the review in the inspector general's next semiannual report.⁸

Finally, in a March 2009 memorandum on government contracting issued to the heads of departments and agencies, President Obama noted that excessive reliance by the federal government on cost-reimbursement contracts "creates a risk that taxpayer funds will be spent on contracts that are wasteful, inefficient, subject to misuse, or otherwise not well designed to serve the needs of the Federal Government or the interests of the American taxpayer." The President directed the Office of Management and Budget to develop guidance to assist agencies in "reviewing, and creating a process for ongoing review of, existing contracts in order to identify contracts that are wasteful, inefficient, or not otherwise likely to meet the agency's needs, and to formulate appropriate corrective action in a timely manner." In this regard, on July 29, 2009, the Office of Management and Budget sent a memorandum to the heads of departments

⁶ This provision was implemented in the Defense Federal Acquisition Regulation Supplement and was effective January 24, 2008. DFARS 234.004.

⁷ Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Pub. L. No. 110-417, § 864.

⁸ This requirement applies only to those executive agencies that awarded cost-reimbursement contracts or issued orders (under contracts previously awarded) of at least \$1 billion in the fiscal year proceeding the fiscal year in which the assessments and reports were submitted.

and agencies requiring agencies to reduce high-risk contracting authorities, such as cost-reimbursement contracts. The memorandum requires agencies to reduce by 10 percent the share of dollars obligated in fiscal year 2010 under new contract actions that are awarded with high-risk contracting authorities.

Full Picture of Agencies' Use of Cost-Reimbursement Contracts Is Unclear

The complete picture of the government's use of cost-reimbursement contracts is unclear. From fiscal years 2003 through 2008, federal obligations under cost-reimbursement contracts were reported to have increased by \$16 billion, from \$120 billion to \$136 billion.⁹ When viewed as a percentage of total reported federal obligations, this represented a decrease over the 6-year period, from 34 percent to 26 percent.¹⁰ However, this decrease is misleading for several reasons, including a significant increase in agencies' reported obligations under the "combination" contract type, which includes cost-reimbursement obligations, and contradictory guidance in the FPDS-NG user manual, which could result in misreporting of contract type. Further, although contract type is a data element field required in FPDS-NG for all awards, we found billions of dollars reported as missing a contract type (i.e., no specific contract type was indicated) or indicating "other" as the contract type. The contract type field displays the type of contract that applies to the particular procurement. It is incumbent on the contracting officers and agencies to ensure the accuracy of all information submitted.

Significant Increase in "Combination" Contract Type Belies Reported Use of Cost-Reimbursement Contracts

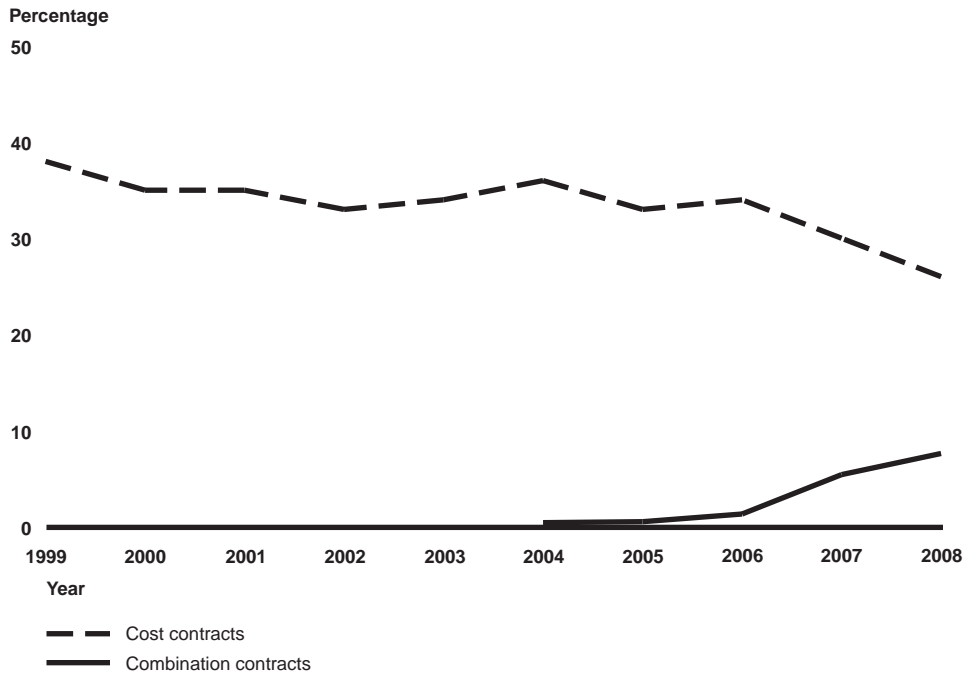
Combination contracts, one of the contract type fields in FPDS-NG, are those where two or more contract types are used, such as in different line items in one contract action. Agencies have recently reported a significant increase in obligations under this contract type, from less than 1 percent (\$1.3 billion) of total government obligations in fiscal year 2004 to almost 8 percent (\$39 billion) in fiscal year 2008. DOD obligations accounted for \$34 billion, or 87 percent, of this amount.

Figure 1 depicts the reported trends in the percentage of total obligations under cost-reimbursement contracts and under combination contracts.

⁹ This amount is in constant fiscal year 2008 dollars.

¹⁰ In order to use consistent data through the time period, we only included actions over \$25,000.

Figure 1: Cost and Combination Type Contracts as a Percentage of Total Obligations, Fiscal Years 1999 to 2008



Source: GAO analysis of FPDS-NG data.

We analyzed fiscal year 2008 FPDS-NG obligations coded as combination contracts and found that half of the \$39 billion was obligated under contracts that had at least some cost-type actions, and about a quarter of this amount (\$9 billion) went to contracts that had 50 percent or more cost-type obligations. These obligations were not recorded as cost-reimbursement in FPDS-NG.

Further illustrating the potential overlap between combination and cost-reimbursement contract types, we found that contracts coded as combination are used to procure similar items as those coded as cost-reimbursement. Our examination of the 15 categories of items most often procured under both cost-reimbursement and combination contract types over the past several years showed substantial overlap. Table 3 depicts the top 15 categories in both contract types and the 11 categories that are the same, from fiscal year 2005 to July 13, 2009, the most current data available at the time of our analysis.

Table 3: Areas of Overlap between Top 15 Categories Reported as Cost-Reimbursement Contract Type and as Combination Contract Type, Fiscal Year 2005 through July 13, 2009

Category reported as cost-reimbursement	Category also reported as combination
Defense systems research and development	X
Professional services	X
Operate government-owned buildings	X
Management support services	X
General healthcare services	X
Space research and development	
Maintenance, repair, and rebuild of equipment	X
Automated data processing and telecommunications	X
Other research/development	X
Aircraft/airframe structure components	X
Defense (other) research and development	X
Motor vehicles, cycles, and trailers	
Space vehicles	
Guided missiles ^a	
General science/technology research and development	X

Source: GAO analysis of FPDS-NG data.

^aGuided missiles was the 16th category reported under the combination contract type.

Because many of the combination contracts include cost-type obligations, those contracts coded as cost-reimbursement do not portray the full picture of the government’s use of cost-reimbursement contracting. FPDS-NG does not delineate what contract types comprise those coded as combination, for example, whether they are cost-plus-award-fee and cost-plus-incentive-fee contracts, or a mix of fixed-price and labor-hour line items.

We also identified conflicting definitions in the FPDS-NG user manual, which agency officials use as guidance when entering contract information into the database, that further complicate efforts to identify obligations under cost-reimbursement contracts. For contracts composed of more than one contract type, instructions direct agencies to “identify the type with greater contract value.” For example, if a contract has both cost-reimbursement and fixed-price portions but the fixed-price portion of the contract makes up 55 percent of the expected contract value, the contract would be coded as fixed-price. However, the very next page of the user

manual describes combination contracts as awards “where two or more contract types apply.” It is not clear, then, whether contracts with more than one contract type should be coded as the contract type representing the preponderance or as combination contracts.

According to a response to a draft of this report by the Office of Federal Procurement Policy (OFPP), a change was recently approved to FPDS-NG, anticipated to be effective for all new contracts awarded in fiscal year 2010, that will eliminate “combination” as a contract type.¹¹ Contracts containing more than one contract type will be coded as the contract type representing the preponderance of obligations. With the elimination of the combination contract type option, the conflicting user manual definitions we identified will be removed.

Missing Contract Types and Obligations Using “Other” Contract Type Contribute to Lack of Clarity about Extent of Cost-Reimbursement Obligations

Although FPDS-NG guidance states that contract type is a required field for all contracts, we found that billions of dollars in obligations are either missing a contract type (i.e., no contract type was reported) or the contract type is indicated as “other.” In fiscal year 2008, over \$10 billion in obligations was reported as missing a contract type and \$4.3 billion was reported as “other.” In addition, some very large contracts that had been previously labeled as cost-reimbursement were subsequently coded as missing a contract type in fiscal year 2008. For example, six Navy contracts with missing contract types had been coded in prior years as predominately cost-reimbursement; in total these contracts accounted for over \$2 billion. Additionally, FPDS-NG guidance prohibited the use of the “other” category as a contract type beginning in fiscal year 2009, but we found contracts in fiscal year 2009, with obligations of \$1.3 billion, that were still using this category. OFPP, in its response to a draft of this report, explained that contracts previously designated as “other” retain that designation when modifications to those contracts are subsequently made. We queried FPDS-NG and verified that the fiscal year 2009 obligations for the “other” contract type were all modifications to contracts awarded earlier than fiscal year 2009. In its response, OFPP noted that agencies have the ability to self-correct the contract type

¹¹ The OFPP Administrator is statutorily required to provide for and direct the activities of the computer-based Federal Procurement Data System (including recommending to the Administrator of General Services a sufficient budget for such activities), which is located in the General Services Administration, in order to adequately collect, develop, and disseminate procurement data. 41 U.S.C. § 405(d)(4)(A).

selection on modifications and stated that it would discuss with agencies the burden associated with making such changes on a voluntary basis (such as for modifications to contracts that were recently awarded and may not expire for a number of years).

Agencies Purchase a Range of Services under Contracts Coded as Cost-Reimbursement

For contracts coded strictly as cost-reimbursement in FPDS-NG, the largest procurement categories in fiscal year 2008 were defense systems research and development, professional services, and the operation of government-owned buildings.¹² The 10 largest procurement categories reported as using cost-reimbursement contracts in fiscal year 2008 are listed in table 4.

Table 4: Ten Largest Procurement Categories Reported as Using Cost-Reimbursement Contracts in Fiscal Year 2008

Procurement	Obligations (in billions)	Percentage
Defense systems research and development	\$17.50	13
Professional services	14.80	11
Operation of government-owned buildings	14.50	11
Management support services	7.80	6
General healthcare services	7.10	5
Space research and development	6.50	5
Maintenance, repair, and rebuild of equipment	6.00	4
Automated data processing and telecommunications	5.80	4
Other research and development	5.70	4
Other	50.30	37
Total reported cost-reimbursement obligations	\$136.00	100

Source: GAO analysis of FPDS-NG data.

Note: These data do not include contract actions coded as "combination," "other," or "missing," which could include cost-reimbursement obligations.

Contracts included in our sample make clearer the range of services agencies are procuring under cost-reimbursement contracts. Table 5

¹² Operation of government-owned buildings is a FPDS-NG designation. The designation includes federally funded research and development centers, such as the Department of Energy's Fermi National Accelerator Center, which conducts high-energy physics research. The buildings at these research centers are government owned and contractor operated.

provides examples of the goods and services procured with cost-reimbursement contracts at the 10 agencies in our review.

Table 5: Examples of Goods and Services Procured with Cost-Reimbursement Contracts at the 10 Agencies in Our Review

Agency	Item or service procured
Corporation for National and Community Service	Administration of Health Benefits Program
Department of the Air Force/Aeronautical Systems Center	Software upgrade on C-17 aircraft
Department of Energy	Management and operation of research laboratory
Department of Health and Human Services/Agency for Healthcare Research and Quality	Medical survey data collection
Department of the Navy/Navy Strategic Systems Program	Technical engineering support services in the area of nuclear survivability analysis
Department of the Treasury/Internal Revenue Service	Development, modernization, and enhancement of E-filing system
Department of Defense/Defense Microelectronics Activity	Study and analysis to define basic requirements for an A-10 multifunction color display upgrade
Environmental Protection Agency/Cincinnati Procurement Operations Division	Analytical lab support to ensure drinking water quality
National Aeronautics and Space Administration/Glenn Research Center	Turbine pump assembly design and development for Ares I
National Science Foundation	Labor, supplies, materials, and support for the planning and science services of the Integrated Ocean Drilling Program

Source: GAO review of agency contract files.

By contrast, the 10 agencies in our review that reported very high use—95 percent or more—of fixed-price contracts procure goods and services for which the requirements are known and research and development is not required, and that are available commercially and have substantial pricing

histories on which to base fixed prices.¹³ For example, officials from the Department of Justice’s Bureau of Prisons told us they procure items for prison operation and maintenance, as well as goods needed to regularly operate these facilities, such as food and inmate clothing. The Department of Agriculture’s Agricultural Marketing Service officials said that they purchase janitorial services, and Defense Commissary Agency officials said they purchase goods, such as groceries, which are sold in commissaries throughout the world. Other examples of procurements by those agencies that had a very high use of fixed-price contracts include fuel, pharmaceutical products, ammunition, office supplies, clothing, and information technology (IT) equipment, according to officials.

Rationale for Using Cost-Reimbursement Contracts Is Often Not Clear, and Analysis Is Not Conducted to Determine if Contract Type with Firmer Pricing Is Warranted

Contracting officials frequently did not document contract files to show why they awarded cost-reimbursement contracts. The documentation we did find, for the most part, used boilerplate language; was short, vague, and repetitive; and did not show why a cost-reimbursement contract was selected. In three cases, documentation in contract files stated that funding unavailability was a reason cost-reimbursement contracts, rather than fixed-price contracts, were awarded. We also found little evidence at the agencies we reviewed that contracting officers are analyzing contract pricing history or requirements to determine if experience under the contract could provide a basis for firmer pricing.

¹³According to FPDS-NG, the U.S. Marshals Service was one of the agencies reporting very high use of fixed-price contracts. However, during discussions with agency officials, we discovered that a significant number of the agency’s contracts were actually labor-hour contracts (a type of a time-and-materials contract) that had been miscoded in FPDS-NG as fixed-price contracts because of the mistaken belief that the fixed labor rate in labor-hour contracts makes them fixed-price. U.S. Marshals Service officials told us that they have taken steps to correct these coding errors. We found a similar issue at other government agencies in our recent review of time-and-materials contracts. See GAO, *Contract Management: Minimal Compliance with New Safeguards for Time-and-Materials Contracts for Commercial Services and Safeguards Have Not Been Applied to GSA Schedules Program*, [GAO-09-579](#) (Washington, D.C.: June 24, 2009).

Little Documentation Available Showing Why Contracting Officers Use Cost-Reimbursement Contracts

Although a formal determination and findings is no longer required to justify a cost-reimbursement contract (as is the case for using time-and-materials contracts), contracting officers are generally required to include in the contract file documentation to show why a particular contract type was selected.¹⁴ The FAR does not contain details as to what this documentation is to entail. Along these lines, a regulatory change is in process to implement a recent congressional direction that acquisition plans set forth the findings necessary to support a decision to use cost-reimbursement contracts. *Standards for Internal Control in the Federal Government* also state that for an agency to manage its operations, it must have relevant, reliable, and timely information relating to internal events. From a management standpoint, that information should be recorded and available to help ensure that this contract type is used only when suitable. Setting forth a full and specific explanation showing why a cost-reimbursement contract was selected for award could, for example, provide agency personnel and their managers with helpful information as they consider awarding future contracts or exercising options on an existing contract.

Of the 92 contract files we reviewed, we found that 28, or 30 percent, contained no documentation showing why a cost-reimbursement contract was selected for award, including in the acquisition plans. Contracting officers frequently could not provide an explanation for its absence, were unaware of the need for documentation, or stated that they inherited the contract from contracting officers who had retired or otherwise left the agency. In one case, the contracting officer told us that the decision to use a cost-type contract was not reduced to a specific document in the file but resulted from discussions. In another case, the contracting officer noted that it was intuitive that the contract was not appropriate for a fixed-price arrangement.

For those contracts that did contain documentation, it was often brief, vague, and repetitive. For example, National Aeronautics and Space Administration (NASA) contracting officers use a boilerplate template on

¹⁴ A formal determination and findings had been required before using cost-reimbursement contracts; *see, e.g.*, 48 C.F.R. § 16.301-3(c) (1993). However, this requirement was repealed by the Federal Acquisition Streamlining Act of 1994, Pub. L. No. 103-355, §§ 1021 and 1071. The act's legislative history indicated that such determinations were unnecessary in light of the acquisition planning requirements of the FAR. See H. Report 103-545, part 2, § 1021, p. 83; Hearing before the Committee on Armed Services, U.S. Senate, April 26, 1994, S. Hrg. 103-578, p. 330.

which they select the appropriate justification, without setting forth the facts and explanation of why this contract type was selected. NASA’s template includes the following choices for why a cost-reimbursement contract should be awarded:

- The level of complexity is moderate to high and performance uncertainties cannot be sufficiently identified or their cost impacts reasonably estimated.
- Changes during performance are: likely _____, unlikely_____, or have an average chance of occurring _____.

The Environmental Protection Agency also uses standard language, not specific to the procurement at hand, to document its rationale for why it awarded a cost-reimbursement contract. For example, two contract files contained the statement, “these activities are non-routine, complex in nature, and specific requirements have not been completely defined.” Two other contract files had the following language: “due to the uncertainties involved in the performance of this contract, costs cannot be estimated with sufficient accuracy to use any type of fixed-price contract.”

Table 6 contains representative examples of rationales we found to be brief and not clearly tied to the individual procurements.

Table 6: Examples of Rationales Used to Show Why Cost-Reimbursement Contracts Were Awarded

Agency	What was procured	Documented rationale
Corporation for National and Community Service	Administration of Health Benefits Program	Uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.
Department of the Air Force/Aeronautical Systems Center	Predator Primary Data Link Secure-Communications Upgrade	Contract type and performance incentives were appropriate to motivate the contractor in the subcontract management area and as an on-time delivery incentive.
Department of Energy	Enhancement of the department’s credibility regarding its activities related to hydrologic, environmental, atmospheric, and soil sciences and human health issues at the Nevada Test Site	A fixed-price type of arrangement is not appropriate because the uncertain duration and specific nature of the work requirements.
Department of Health and Human Services/Agency for Healthcare Research and Quality	Support of the HIV Research Network	There are uncertainties involved in contract performance that do not permit costs to be estimated with sufficient accuracy to use a fixed-price contract. The work to be performed is such that it is not feasible to devise predetermined objective incentive targets applicable to cost, technical performance, or schedule.

Agency	What was procured	Documented rationale
Department of the Navy/Navy Strategic Systems Program	Systems tactical engineering support and test engineering support to deployed systems for MK5 and MK6 guidance program	The exact nature of this procurement effort cannot be established in advance with the certainty required for a firm fixed-price contract nor can the cost of the work be accurately forecasted to permit the undertaking of such work for a fixed price.
Department of the Treasury/Internal Revenue Service	Support services for Automated Collection System Support	The work and nature of the services to be performed and the uncertainties involved in the contract performance are such that cost of performance cannot be estimated with sufficient reasonableness to permit use of any type of fixed-price contract.
Department of Defense/Defense Microelectronics Activity	Tracking analysis and track integration	Reasonable and firm performance objectives and schedules that have not been firmly established and the amount of effort required is not fully known.
Environmental Protection Agency/Cincinnati Procurement Operations Division	Support and development of BASINS (Better Assessment Science Integrating Point and Nonpoint Sources)	Because of uncertainties involved in the performance of this contract, costs cannot be estimated with sufficient accuracy to use any type of fixed-price contract.
National Aeronautics and Space Administration/Glenn Research Center	Aeronautics communications and education support	Level of complexity is moderate to high and performance uncertainties cannot be sufficiently identified or their cost impacts reasonably estimated. Changes are likely.
National Science Foundation	Meeting planning, logistical, and administrative support services	We have selected this type of contract because of the uncertainties of requirements.

Source: GAO review of agency contract files.

The Navy Strategic Systems Program, in addition to the standard language showing why it selected cost-reimbursement contracts, provided us with a briefing explaining that a primary reason for using cost-reimbursement contracts is the emphasis this office places on the safety, reliability, quality, and readiness of the nuclear weapons it procures. Shifting too much risk to the contractor, the Navy states, would increase the risk that safety, reliability, quality, and readiness could be compromised because, when problems are encountered, contractors are motivated not to lose money and to look for ways to cut costs. Cutting costs can translate to performance degradations that may not surface until years later. Navy officials also told us that cost-reimbursement contracts for nuclear weapons are cost-effective because the high technical risk of what is being procured would expose contractors to great financial risk with a fixed-price contract, causing contractors to mitigate such risk with proposals that would be prohibitively expensive.

One contract file in our review did include a more specific rationale for using a cost-reimbursement contract type. A memorandum in a NASA contract file justified the use of a cost-reimbursement contract to procure traveling wave tubes, a component of electronic equipment. The memorandum stated that “because of the high breakage rate which occurs

during fabrication of Traveling Wave Tubes, a fixed-price contract would be too costly for the government. Consequently, a cost-type contract is the chosen method of procurement.”

**Funding Availability
Sometimes Drove Decision
to Use Cost-
Reimbursement Contracts**

In some cases, we found that it was not necessarily uncertainty about requirements that drove the selection of a cost-reimbursement contract, but rather uncertainties about funding availability. Some contracting officers told us that cost-reimbursement contracts could be modified more easily than fixed-price contracts as more funding became available (if, for example, funding was made available on a periodic basis instead of at the beginning of the fiscal year), whereas fixed-price contracts were required to be fully funded up front. For example, a contracting officer at the National Science Foundation (NSF) noted that as a result of the ambiguities of the services provided and the funding available each year, a fixed-price contract was not possible for the procurement. However, the contracting officer said that even if there were no ambiguities regarding the services to be awarded, if funding availability was incremental and uncertain then the contract would be awarded on a cost-reimbursement basis. At the Internal Revenue Service (IRS), one of the contract files we reviewed contained documentation stating the following:

“The customer did not have sufficient funding available to structure the task order and obligate the funding under a firm fixed price (FFP) structure. As a result, a Cost Plus Fixed Fee ... was awarded. The customer estimated their requirement at \$8.1 million; however, they were only able to provide \$2.1M at the time of award. After initial award, four (4) additional increments of funds were provided to incrementally fund this requirement in the first year. Given our continuous cycle of Continuing Resolutions each Fiscal Year, our use of Cost Reimbursement contract vehicles are the most practical awards.”

In our view, the perceived ease of adding funding under cost-reimbursement contracts as funding is made available is not a correct assumption. Under a cost-reimbursement contract, an agency is required to obligate the estimated costs (or ceiling) established in the base year contract for the required services or products at the time of award. When modifications are approved increasing the original funding ceiling in the contract award, the increased costs are charged to the appropriation current at the time of the modification. It is true that modifications of fixed-priced contracts can be charged against the funding available at the time of the original contract award, depending upon the type of contract modification. However, agencies must obligate the ceiling amount under a

cost-reimbursement contract based upon a reasonable estimate of costs for providing the service or product. Agencies cannot simply limit the amount of a recorded obligation by stating that the contract is limited to an amount of funding available for the contract or stating that the contract will be incrementally funded if those amounts are different than the estimated ceiling costs.¹⁵

At the Air Force Aeronautical Systems Center, we found that the availability of research and development funds—as opposed to procurement—was a reason for awarding a cost-reimbursement contract. The price negotiation memorandum for one contract we reviewed stated that “The Government directed the contractor to bid the effort as firm fixed price. (The contractor) submitted a firm fixed price in response The Government later changed direction ... in order to use FY07 3600 funds.”¹⁶ There was no additional indication in the contract file as to the reason the decision was made to switch to a cost-reimbursement contract. We were unable to discuss the reason for switching with the contracting officer because the contracting officer had left the agency.

Agency Officials Are Not Conducting Analysis to Determine Potential to Transition to Contract Types with Firmer Pricing

The FAR does not specifically require a transition plan from a cost-reimbursement contract to one with firmer pricing. However, the FAR states that in the course of an acquisition program, a series of contracts, or a single long-term contract, changing circumstances may make a different contract type appropriate in later periods than that used at the outset. In particular, contracting officers should avoid the protracted use of a cost-reimbursement contract after experience provides a basis for firmer pricing,¹⁷ for example, by transitioning part or all of the requirements to a fixed-price contract. Information important to such an effort would include a contracting officer’s analysis of the contract’s pricing history and the results of program offices revisiting the government’s requirements to determine whether they can be better defined. In this regard, on July 29,

¹⁵ See B-317139, June 1, 2009. In some circumstances, services contracted under cost-reimbursement contracts and other types of contracts may be charged to funding available during subsequent fiscal years. This may depend upon whether the services are severable or nonseverable. See *id.*

¹⁶ The designation “3600 funds” is the Air Force designation for budget authority appropriated for research and development. The record is not clear as to why research and development and not procurement funds were available.

¹⁷ FAR Subpart 16.103(b).

2009, the Office of Management and Budget issued a memorandum requiring agencies to reduce high-risk contracting instruments, such as cost-reimbursement contracts. Using fiscal year 2008 as a baseline, the memorandum states that agencies should aim to reduce by at least 10 percent the combined share of dollars obligated through new contracts in fiscal year 2010 that (1) are awarded noncompetitively, receive only one bid in response to a solicitation or a request for quote, or both; (2) are cost-reimbursement contracts; or (3) are time-and-materials and labor-hour contracts. To meet this goal, the memorandum states that agencies might plan for the migration of work from cost-type to fixed-price contracts as requirements become better defined.

We did not assess whether an agency's decision to use a cost-reimbursement contract was the most appropriate choice of contract type during our review, but we generally found no evidence that agency officials assessed, for example, the contract's pricing history or requirements under the contracts we reviewed to determine whether there was a basis for firmer pricing, even when the contracts had been in place for several years. For example, NSF awarded a \$2.8 million cost-reimbursement contract in 2007 to collect and analyze data for a survey of science and engineering research facilities. NSF has been conducting the survey since 1986 and noted in its acquisition plan that methodological studies have been performed during each cycle to improve the design and processes for subsequent cycles. However, the documentation showing why the agency selected a cost-reimbursement contract, rather than one with firmer pricing, was vague, stating that the survey tasks include "analysis work involving several uncertainties, and sufficient room during the collection process for variegated opportunities to revise and improve on survey methods, creating additional areas of uncertainty." Although contracting officers are to consider the cost-reimbursement contracts' pricing history, there was no evidence in the contract file that this occurred—or that the program office had revisited requirements—to determine whether there was a basis to convert to a contract type with firmer pricing. In another example, the Agency for Healthcare Research and Quality (AHRQ) awarded a contract to collect data for its annual Medical Expenditure Panel Survey. The contract, awarded in 2002 with options extending through 2008, was worth over \$128 million with the options included. The same contractor had performed this survey since 1996, but the contract file contained no evidence regarding why a cost-reimbursement contract continued to be used, despite having at least 6 years of data regarding costs and requirements.

We found cases where leadership had encouraged movement away from cost-reimbursement contracts, largely by focusing on the program offices' role in establishing firmer requirements. An IRS contracting office, for example, recently established a contract review board to review the use of cost-reimbursement contracts supporting a multibillion-dollar IT modernization program that has been in place for over 20 years.¹⁸ Cost-reimbursement contracts had initially been determined to be in the government's best interest because IRS was unable to define its requirements sufficiently to allow for fixed-price contracts. According to IRS officials, over time cost-reimbursement contracts and orders continued to be awarded and issued for this program because it was easier. In effect, maintaining the status quo became the way contracting was done. Officials told us that the partnership between the contracting and program office was weak; one contracting officer told us that a source selection was conducted, the acquisition plan written, and proposal evaluation made without any input from the contracting officer. In January 2008, new leadership at this IRS contracting office established a contract review board to review and approve procurements proposed as cost-reimbursement contracts. The IRS Director, Office of Information Technology Acquisition, told us that the review board represented a significant paradigm shift from how business was conducted. In one case, the board stopped a planned sole-source, cost-reimbursement order from being awarded in favor of a competitive, firm-fixed-price task order. The order was awarded for approximately \$9.5 million—about half of the government estimate and \$15 million less than what the contractor requested as a sole-source provider.

We also found two additional cases where agencies had contracted for IT services on a firm, fixed-price basis. While we recognize that IT services vary significantly in terms of complexity, in these cases contracting officials had made a concerted effort to work with the program offices to define requirements such that vendors could submit offers on a fixed-price basis. Procurement officials at the District of Columbia's Pretrial Services Agency¹⁹ and the Department of Agriculture's Farm Services Agency—two

¹⁸ A February 2009 Department of the Treasury Inspector General for Tax Administration report found that IRS contract files lacked justification for cost contracts. It also found that IRS had a predisposition to use cost-reimbursement contracts and made little effort to convert follow-on work to less risky contract types.

¹⁹ The District of Columbia Pretrial Services Agency was designated a federal agency in 2000.

agencies with high proportions of fixed-price contracts—noted that IT services contracts were among their largest obligations under fixed-price contracts. Both of the agencies were successful at implementing these contracts as fixed-price contracts because their technical personnel (i.e., officials in their program offices) were required to separate and define their IT contract requirements into specific, measurable deliverables. The head of contracting activity at the Farm Services Agency told us that it was “a long road” to get the program office on board with this approach, as the office had preferred cost-reimbursement contracts for IT services in the past, but that the effort paid off in terms of savings as well as a greater likelihood that the government would get the deliverables it expected. This official emphasized that a key to the agency’s success was including its technical personnel in the contracting process.

Agencies Do Not Always Ensure That Contractors’ Accounting Systems Are Adequate for Determining Costs Applicable to Contracts

Cost-reimbursement contracts are to be used only when the contractor’s accounting system is adequate for determining costs applicable to the contract. This determination is critical because it helps assure the government that the contractor has systems in place to accurately and consistently record accumulated costs and bill for allowable costs. If accounting systems are not deemed adequate, problems can arise when costs are accumulated during contract performance.²⁰ Contracting officers have a number of methods available to them to make this determination. One method is to rely upon assessments of accounting systems prepared by DCAA for prior contracts. The FAR does not specify a time frame within which an accounting system needs to be determined adequate to be used as a basis to award a new cost-reimbursement contract. As such, for the purposes of this review, we used a period of 4 years, which is the outermost time frame in DCAA policy, as being “current” for auditing an accounting system that has a significant impact on government contract costs.

Another method by which contracting officers can determine if an accounting system is adequate is to perform a pre-award survey of a

²⁰ The contractor has until the time performance begins to meet the accounting system requirement. For purposes of this report, we equate this to the time the contract was awarded.

prospective contractor's accounting system.²¹ According to the FAR, determining that an accounting system is adequate as part of a pre-award survey includes a determination of whether it is in accordance with generally accepted accounting principles and whether it provides for

- a proper segregation of direct costs from indirect costs,
- an identification and accumulation of direct costs by contract,
- a logical and consistent method for the allocation of indirect cost to intermediate and final cost objectives,
- an accumulation of costs under general ledger control,
- a timekeeping system that identifies employees' labor by intermediate or final cost objectives,
- a labor distribution system that charges direct and indirect labor to the appropriate cost objectives, and
- an interim (at least monthly) determination of costs charged to a contract through routine posting of books of account.

The contracting officer is responsible for verifying that the contractor has an adequate accounting system.²² For most of the contracts we reviewed, this verification was based on a DCAA opinion stemming from its review of the contractor's accounting system and related internal control policies and procedures, but the opinion can also be rendered by an independent

²¹ FAR 53.301-1408, FAR Form 1408; FAR 9.106-4. An agency's determination of whether a contractor has an adequate accounting system is part of a responsibility determination of a prospective awardee, that is, determining that the firm has the ability or capacity to perform the contract. FAR 9.103; 9.104-1(e). The contractor has until the time performance begins (i.e., when the contractor begins the work) to meet the accounting system requirement. For purposes of this report, we equate this to the time the contract was awarded. In making this responsibility determination, a contracting officer can request a pre-award survey from DCAA of a prospective contractor's accounting system, but is only required to do so when the information on hand or readily available is not sufficient to make this determination. FAR 9.106-1(a); FAR 9.105-1(b)(2). DCAA normally issues a Standard Form 1408 "Pre-award Survey of Prospective Contractor—Accounting System" (FAR 53.301-1408). To complete this form, the audit scope should be limited to obtaining an understanding of the prospective accounting system's design to determine whether the design is acceptable for accumulating costs under a government contract; it is not necessary to conduct an in-depth evaluation of the overall accounting system. *DCAA Contract Audit Manual*, section 5-202.a; DCAA Information for Contractors, section 2-301.1.a.

²² Particularly for large dollar value contracts, an administrative contracting officer may be assigned to handle contract administration as opposed to contract award. In the case of DOD, Defense Contract Management Agency personnel are typically assigned as the administrative contracting officers.

accounting firm or other designated entity.²³ According to the DCAA Contract Audit Manual, each relevant accounting or management system that has a significant impact on government contract costs should be audited on a cyclical basis, that is, every 2 to 4 years, depending on a documented risk assessment of experience and current audit risk.

Regular accounting system reviews are necessary to help ensure that changes to the contractor's accounting practices are considered by the government and evaluated for compliance with government contract cost principles. Over the period of a contract, the contractor's cost structure or accounting procedures can change because of multiple factors, such as changing the criteria for capitalizing or depreciating assets, applying different indirect cost allocation bases, or merging of a contractor's various operating segments. By continuing to pay a contractor without taking into account these changes, the government risks paying for unallowable costs. The contracting officer takes into account DCAA's opinion, or that of the designated entity, but retains the ultimate authority for determining whether the contractor's accounting system is adequate.

As an example of what can occur when the determination of adequacy is not made or the contractor's accounting systems are not deemed adequate, in August 2007, a contractor disclosed to the Air Force that it had periodically overbilled on the Joint Strike Fighter Systems Development and Demonstration cost-reimbursement contract since its inception. The amount overbilled was about \$267 million. In this case, DCAA had rendered the opinion that the contractor's accounting system was "inadequate in part." The contractor reimbursed the Air Force for the amount overbilled and paid an additional \$28 million in interest.

Timely Accounting System Approval in 52 Cases Reviewed; 13 Others Approved After Award

Of the 92 contract files we reviewed, only 52 (about 57 percent) had any evidence that contractors' accounting systems had been deemed adequate in a current time frame (within 4 years or less) before contract award. Other accounting systems had been deemed adequate either after award or not at all. Where the contract files contained no evidence of an adequacy determination, we interviewed the cognizant contracting officers to confirm the lack of evidence. Table 7 depicts the results of our analysis of contract files and discussions with contracting officers.

²³ Although DCAA plays a critical role in DOD contractor oversight, it also performs audit services for other federal agencies, on a fee-for-service basis.

Table 7: Adequacy of Contractors' Accounting Systems

Status of accounting system adequacy	Contracts/orders		Number of contractor accounting systems ^a
	Number	Percent	
Determined adequate in current time frame before award	52	57	40
Determined adequate before award but not in current time frame	7	8	6
Determined adequate after contract award	13	14	11
No evidence of accounting system adequacy pre- or post-award	20	22	20
Total	92	100^b	

Source: GAO analysis based on contract file data and interviews with agency officials.

^aSeveral contractors had multiple contracts, orders, or both but only one accounting system.

^bNumbers do not add to 100 because of rounding.

Thirteen contract files in our sample indicated that contractor accounting systems were determined adequate after contract award; the contracts were awarded before any determination that the accounting systems were adequate for determining cost. For example, the Department of Energy (DOE) awarded a contract in October 1996, but the accounting system was not determined to be adequate until July 1998, more than 2 years after the contract was awarded.

Approval for Seven Accounting Systems Occurred More Than 4 Years Prior to Award

Seven of the contract files we reviewed revealed that accounting systems were not determined adequate before award within current time frames. For example, NASA awarded a contract with an estimated value of more than \$205 million (with options) in April 2005. However, the contractor's accounting system was last determined to be adequate on a prior contract in August 1998, more than 7 years before the award of the current contract.²⁴ In another example, at the Defense Microelectronics Activity,

²⁴ DCAA reported on December 3, 2004, that the contractor's accounting system was adequate, based on its August 24, 1998, audit, rather than work performed within 4 years of contract award.

DCAA found a contractor's accounting system to be inadequate in part.²⁵ The contractor took corrective action, resolving some of the deficiencies to DCAA's satisfaction; the Defense Contract Management Agency (DCMA) found that the remaining deficiencies were not material to government contracts and concluded that the contractor's accounting system was adequate. A previous determination, based on a DCAA opinion, that the contractor's accounting system was adequate, was made by DCMA in 2001—5 to 6 years before the orders we reviewed were issued.

No Evidence of Accounting System Adequacy for 20 Contracts

We found no evidence, either pre- or post-award, of determinations that the contractors' accounting systems were deemed adequate for 20 of the contracts we reviewed (with a total value of more than \$1.4 billion, not including option periods). This means that contracting officers obligated funds without knowing whether the contractors had accounting systems capable of billing the government properly. These 20 contracts were from the following agencies:

- NSF - 4 contracts
- NASA - 2 contracts
- Air Force Aeronautical Systems Center - 3 contracts
- Corporation for National and Community Service - 1 contract
- AHRQ - 10 contracts

Contracting officials confirmed the lack of evidence in the contract files. However, most could not provide an explanation for why this was the case, or were not aware of their responsibility for ensuring that contractor accounting systems are determined adequate for cost-reimbursement contracts. Some said that they inherited the contracts from contracting officers who retired or otherwise left the agency. Further, a DCMA official incorrectly told us that the contractor's accounting system is presumed to be adequate unless it is otherwise documented that the accounting system is not adequate.

Four of these contract files contained opinions by DCAA that the accounting systems were inadequate in part. According to DCAA internal control criteria, an inadequate in part opinion meant that one or more

²⁵ A DCAA inadequate in part opinion meant that one or more significant deficiencies affected parts of the accounting system. By contrast, a DCAA inadequate opinion means one or more significant deficiencies render the entire accounting system unreliable.

significant deficiencies existed that affected parts of the accounting system. Such an opinion required the contractor to take corrective action and could require DCAA to review contractor invoices. For example, one of the Air Force Aeronautical Systems Center contracts we reviewed showed that DCAA found the contractor's accounting system to be inadequate in part. According to the administrative contracting officer, the inadequate in part opinion was significant enough to preclude the contractor from direct billing the Defense Finance and Accounting System for payment and required the contractor to submit invoices to DCAA for review and approval before payment could be made to the contractor. On December 19, 2008, DCAA issued audit guidance stating that it will no longer report inadequate in part opinions. Audit reports that report any significant deficiencies or material weaknesses will include an opinion that the system is inadequate.

At AHRQ, none of the contract files we reviewed contained documentation stating that the contractors' accounting systems had been deemed adequate for determining costs applicable to the contracts at any time. Three of these contract files contained memos from the former AHRQ senior staff accountant stating that although his review did not consider the adequacy of the contractors' financial capability or their accounting systems, nothing came to his attention to preclude an award on this basis. The contracting officers told us that they had relied on the National Institutes of Health's (NIH) negotiation of indirect cost rates for these contracts. But according to the NIH Director of Financial Advisory Services, this indirect rate negotiation does not satisfy the FAR requirement that a contractor's accounting system is deemed adequate for determining costs applicable to its contracts.²⁶

²⁶ An indirect cost is a cost a contractor incurs for a common or joint objective that cannot be specifically identified, in its entirety, with a particular cost objective. Typical indirect costs include the costs of operating and maintaining facilities, equipment, and grounds and administrative salaries and supplies. Indirect cost rates are negotiated to ensure that only the portion of those indirect costs needed to support the contract is reimbursed to the contractor.

Various Procedures for Cost Surveillance Require Effective Implementation to Avoid Improper Payments

For the agencies in our review, we found a range of cost surveillance procedures. Cost surveillance procedures under cost-reimbursement contracts are intended to help ensure that the contractor is performing efficiently and effectively and that the government pays only for allowable, allocable, and reasonable costs applicable to the contract. Lack of adequate cost surveillance can lead to overpaying the contractor. The civilian agency procedures call for program officials to review contractors' invoices. DOD procedures do not include invoice review by program offices, but rely on monthly reviews of contractors' costs and a project management tool called Earned Value Management (EVM), supplemented by periodic DCAA audits. Whether cost surveillance is done by reviewing invoices or by the methods used by DOD, the key is effective implementation to help avoid improper payments or overbilling.

Cost Surveillance Procedures at Civilian Agencies

Procedures in the civilian agencies in our review generally call for contracting officers' representatives (COR) to examine contractor invoices. CORs are appointed by the contracting officer to assist in the technical monitoring or administration of a contract. Invoice reviews help to ensure that the goods and services for which the government is being billed were actually received, the amounts billed are allowable, and the government is not incurring claimed costs that are inadequately supported. Agency officials outlined the steps in the cost surveillance process as follows.

- The program office directs work to be done, consistent with the contract's statement of work.
- How the work is done, together with the time and cost required to do the work, is proposed by the contractor and, upon approval by the program office, becomes a work request. Work requests describe the work to be done, the labor categories needed, and the hours required by each labor category to complete the work.
- As invoices are submitted, the CORs are supposed to reconcile the invoices to the work requests to ensure that the government only pays for the completed work authorized by the work requests.

Some CORs told us that they also pay attention to the labor categories charged to ensure that the contractor is billing for the level of expertise actually used to do the work and the hours worked. Once an invoice is reconciled, payment is made. Should a contractor experience technical problems, which may cause cost overruns, the COR must determine if the technical problems are legitimate before the government will approve continued work and invoices for payment.

The efficacy of invoice review depends on an agency's policies and procedures and the diligence and expertise of the COR in implementing them. Another factor is the time CORs have available to devote to oversight duties. We have reported that CORs are often assigned these oversight functions as an additional duty.²⁷ In addition, we reported in 2007 that DOE was not adequately reviewing invoices for a multibillion-dollar cost-reimbursement contract to design and construct the Hanford waste treatment plant, risking hundreds of millions of dollars in improper payments.²⁸ Instead, DOE relied primarily on DCAA's review and approval of the contractor's financial systems and on the contractor's review and approval of subcontractor charges. DOE's heavy reliance on others, with little oversight of its own, exposed the hundreds of millions of dollars it spent annually on the project to an unnecessarily high risk of improper payments. In September 2008, DOE amended its acquisition guide to hold contracting officers responsible for ensuring that contract invoices are properly reviewed and analyzed before any payment is made to contractors.

DOD Reliance on Contractor-Provided Program Management Data May Be Inadequate if Required Audits Are Not Conducted to Supplement Cost Surveillance

At DOD, procedures for monitoring contractor costs depend in large part on the EVM system—a tool that presents contractor-provided data to measure the value of work accomplished in a given period compared to the planned value of work scheduled and the actual cost of work accomplished—supplemented with audits for the purpose of testing whether invoiced costs are allowable.²⁹ DOD policy dictates that CORs shall not be delegated authority to approve invoices (as this is the role of DCAA and administrative contracting officers), but they may review contractor billings to determine whether the hours billed and labor mix are commensurate with the work performed. CORs and program officials responsible for surveillance for the DOD contracts in our sample told us that they rely on contractor-provided monthly reports and EVM data to perform cost surveillance. EVM data do not provide surveillance of

²⁷ GAO, *Contract Management: Opportunities to Improve Surveillance on Department of Defense Service Contracts*, [GAO-05-274](#) (Washington, D.C.: Mar. 17, 2005).

²⁸ GAO, *Hanford Waste Treatment Plant: Department of Energy Needs to Strengthen Controls over Contractor Payments and Project Assets*, [GAO-07-888](#) (Washington, D.C.: July 20, 2007).

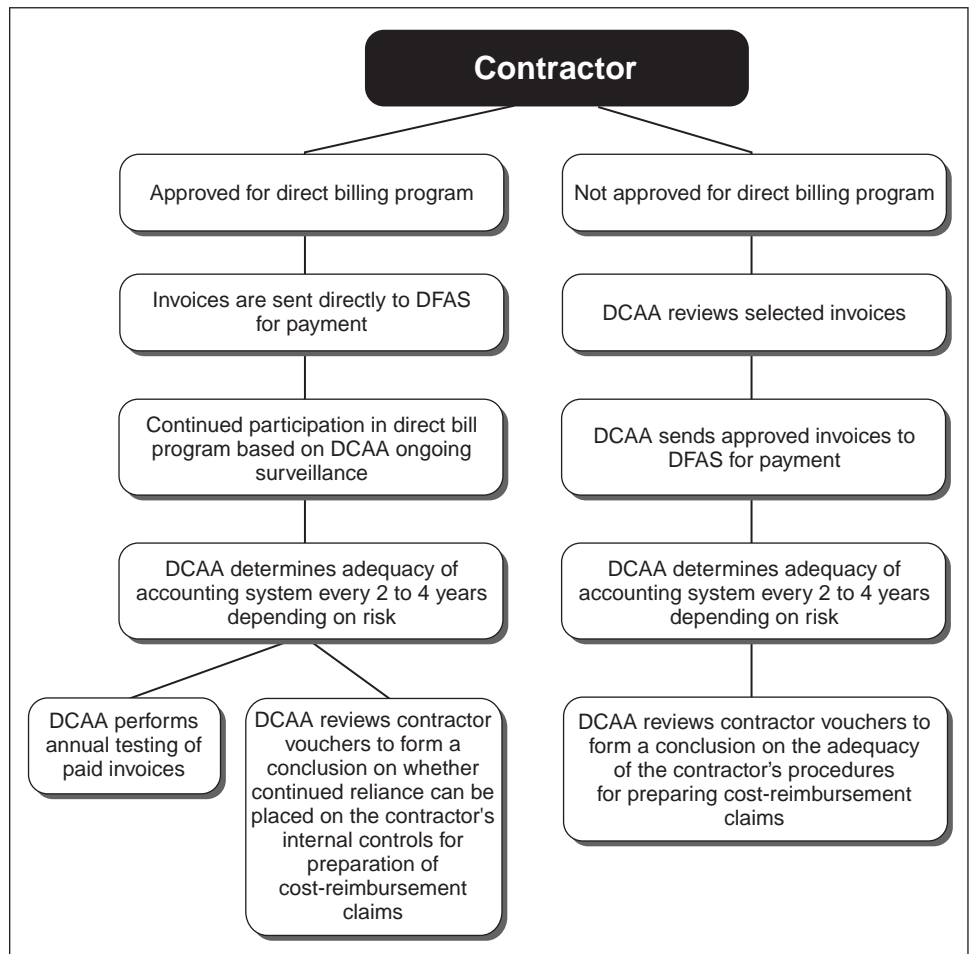
²⁹ The Office of Management and Budget mandates use of EVM for capital assets (Circular A-11, part 7) and for new, major IT projects, ongoing IT development projects, and high-risk projects (OMB Memorandum M-05-23, Aug. 4, 2005).

specific contract costs, as would be presented in an invoice, but are intended to alert program managers to potential problems with cost or schedule overruns sooner than a review of contract expenditures (such as an invoice review) alone would.³⁰ At the same time, however, the EVM data's level of detail at the contract and order level can be much less than that of an invoice—where the specifics in terms of labor categories, travel, and equipment would be reflected.

Therefore, analysis of EVM data alone does not satisfy FAR requirements for cost surveillance under cost-reimbursement contracts. In addition to the key control discussed above—determining that the contractor's accounting system is adequate—the EVM data must be supplemented with audits for the purpose of testing whether invoiced costs are allowable. DOD has two main sets of procedures in place to do this, one for when the contractors are approved for direct billing and one for when they are not. Direct billing allows approved contractors to send their invoices directly to the Defense Finance and Accounting Service for payment, without invoice review by either DCAA or the COR. DCAA is required to perform annual review of paid invoices. In addition, for contractors approved for direct billing, DCAA performs incurred cost audits and conducts “floor checks” at contractor facilities to test the reliability of such things as employee time records and job classifications. To be eligible to participate in the direct billing program, contractors must meet certain criteria, such as having an adequate accounting/billing system and related internal controls, as determined by DCAA. If a contractor is not eligible to participate in the direct billing program, the contractor must submit all cost-reimbursement interim invoices to DCAA for approval for provisional payment. DCAA then submits them to the Defense Finance and Accounting Service for payment. Figure 2 depicts these various procedures.

³⁰ An example would be a contract that calls for 4 miles of railroad track to be laid in 4 weeks at a cost of \$4 million. After 3 weeks of work, only \$2 million has been spent. An analysis of planned versus actual expenditures suggests that the project is running under its estimated costs. However, an earned value analysis reveals that the project is in trouble because even though only \$2 million has been spent, only 1 mile of track has been laid and, therefore, the contract is only 25 percent complete. Given the value of work done, the project will cost the contractor \$8 million (\$2 million to complete each mile of track), and the 4 miles of track will take a total of 12 weeks to complete (3 weeks for each mile of track) instead of the originally estimated 4 weeks.

Figure 2: DOD Procedures for Process and Approval of Interim Invoices



Source: GAO, based on review of DCAA Contract Audit Manual.

The effectiveness of DOD’s cost surveillance process depends, to a large extent, on the adequacy of these DCAA procedures. Our recent work has raised concerns in this regard.³¹ For example, rather than documenting the population of invoices, preparing sampling plans, and testing a random (statistical) sample, as should be done, auditors generally used a nonrepresentative selection of invoices in deciding the number of invoices

³¹ GAO, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, [GAO-09-468](#) (Washington, D.C.: Sept. 23, 2009).

they would review and the extent of testing they would perform to support conclusions in their work. For example, we found that for one contractor that generated \$1.1 billion in annual billings to the government, the DCAA auditor only reviewed 3 invoices totaling \$88,000 out of 222 invoices submitted for payment from March 2003 through February 2004, tested the first invoice selected, and performed limited testing on the remaining 2 invoices. Despite this limited testing, DCAA prepared a memorandum for the record, stating that “continued reliance can be placed on the contractor’s procedures for the preparation of interim vouchers (invoices)” and “the contractor has met the criteria for continued participation in the direct billing program.” Also, we recently testified that allegations that certain audits at three locations did not meet professional standards were substantiated.³² Specifically, contractor officials and the DOD contracting community improperly influenced the audit scope, conclusions, and opinions in three cases, a serious independence issue. At two DCAA locations, we found evidence that (1) working papers did not support reported opinions, (2) DCAA supervisors dropped findings and changed audit opinions without adequate evidence for their changes, and (3) sufficient audit work was not performed to support audit opinions and conclusions.

In our review, we found an additional example of what can happen when adequate cost surveillance is not in place. NSF awarded a \$1.1 billion, 10-year 5-month cost-reimbursement contract (with options) for logistic and operational support for the U.S. Antarctic Program. As discussed in a series of NSF Office of Inspector General audit reports, DCAA found that the contractor was billing indirect costs as direct costs, billing over the negotiated ceiling limitations, and not providing supporting documentation for other costs. To compound these issues, NSF had not determined that the contractor’s accounting system was adequate for determining costs applicable to its contract. In November 2007, an independent auditor reported that NSF had significant weaknesses in its contract monitoring policies and procedures, meaning that the agency did not know whether the costs it was paying the contractor were allowable and reasonable. NSF officials acknowledged the weaknesses and have begun to take corrective action.

³² GAO, *DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated*, [GAO-08-993T](#) (Washington, D.C.: Sept. 10, 2008).

As a final example of inadequate cost surveillance, in January 2009, the DOE Inspector General reported weaknesses in a contractor's internal audit, which DOE relies on to help ensure that contractors' costs charged to DOE are allowable under the terms of the contract.³³ For fiscal year 2007, the contractor had expended and claimed over \$1.4 billion. The Inspector General found that the contractor's internal audit during fiscal year 2007 was not satisfactory in several material respects. Specifically:

- Procurements were not properly approved, but the contractor's internal audit management permitted the contractor to provide approvals 3 years after the fact. Questioned costs associated with the procurements were omitted from the contractor's audit report.
- The contractor's internal audit manager encouraged the omission of information that confirmed improper labor cost allocations.
- After the completion of audit testing, the contractor's internal audit management directed the modification of the testing attribute related to independent receipt of procured goods and services, an action that caused some of the questioned costs to be excluded from reporting.

As a consequence, DOE managers at the Savannah River Site were not provided with the information necessary to fully comprehend the materiality of, or to address and resolve, internal control weaknesses. The contractor did not agree with all of the Inspector General's findings, but did acknowledge weaknesses and indicated that it planned to address them.³⁴

³³ In 1992, DOE implemented the Cooperative Audit Strategy to maximize audit coverage of facility contractors. As part of that strategy and as required by contract, each contractor is to maintain an internal audit function acceptable to DOE. In turn, the DOE Office of Inspector General is supposed to assess the contractor's internal audit staff's qualifications, independence, and workpapers, and test the work performed by the contractor's internal audit staff. Department of Energy, Office of Inspector General Office of Audit Services, *Audit Report: Washington Savannah River Company, LLC, Internal Audit Function*, DOE/IG-0811 (Washington, D.C., January 2009).

³⁴ In technical comments on a draft of this report, submitted to us on September 28, 2009, DOE's Assistant Secretary for Environmental Management stated that the department uses a variety of mechanisms, not just internal audits, to ensure that contractors' costs charged to DOE are allowable. The Assistant Secretary noted that the DOE Inspector General report we cite represents an example of an internal control specifically required by the Cooperative Audit Strategy. According to the official, DOE managers at the Savannah River Site investigated the questioned costs identified by the Inspector General and found that the costs were allowable, but DOE acknowledges the internal control weaknesses and has increased the level of oversight in this area.

Conclusions

Cost-reimbursement contracts are appropriate when contracting for requirements that involve substantial uncertainties, but they require careful management to protect the government's interests. At a macro level, careful management is enabled by good information. Current reporting in FPDS-NG, specifically regarding the combination contract type and billions of dollars with missing contract types, does not provide decision makers with adequate visibility into the government's use of cost-reimbursement contracts. Further, while the FAR cautions against the protracted use of cost-reimbursement contracts after experience provides a basis for firmer pricing, it does not set forth procedures or provide guidance for doing the analysis needed to make this determination. We found little evidence that agency officials are analyzing whether such a transition can be made. While recent congressional and executive branch actions are intended to help ensure that cost-reimbursement contracts are used only when appropriate, they have yet to take full effect.

Recommendations for Executive Action

We recommend that agency officials take the following four actions to address the cost-reimbursement contract issues we found.

To help ensure that analysis is conducted to determine whether to continue using cost-reimbursement contracts when experience may provide a basis to transition to firmer pricing, we recommend that the Administrator of OFPP take steps to amend the FAR. Specifically, we recommend that the Administrator require procedures for contracting officers (in conjunction with the requiring activity) to analyze, before the award of a new contract or at other appropriate times during a contract's period of performance, the agency's requirement and determine if its experience with a procurement provides a basis for firmer contract pricing. The results and findings of this analysis should be documented in the contract file. If the analysis indicates that a basis for firmer pricing does exist, the procedures should require consideration, modification, and implementation, if feasible, of an acquisition plan to transition to a contract type with firmer pricing.

To help clarify reporting requirements in FPDS-NG to provide a clearer picture of the extent to which various contract types, including cost-reimbursement, are being used, we recommend that the Administrator of OFPP

- implement controls in FPDS-NG to preclude information from being entered without a contract type being identified, that is, eliminate the "missing" contract type option and

-
- reconcile the conflicting instructions in the FPDS-NG user manual for coding combination contracts versus coding based on the preponderance of contract type.

We also recommend that the Secretary of Health and Human Services direct the Director of AHRQ to provide guidance to the agency's contracting staff to ensure that they are aware of their responsibility to ensure that contractors' accounting systems have been deemed adequate before awarding cost-reimbursement contracts.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from OFPP, the Departments of Defense, Energy, Health and Human Services, and Treasury; NASA; the Environmental Protection Agency; NSF; and the Corporation for National and Community Service. In comments provided via e-mail, OFPP agreed with the recommendations directed to it. The response stated that OFPP would work with the FAR Council to address the issue of setting forth procedures for determining whether analysis may indicate a basis for firmer contract pricing based on contract pricing history and requirements. OFPP also stated that version 1.4 of FPDS-NG (with a projected launch of February 2010) will make the selection of a contract type mandatory, so that new contract awards will no longer be coded as missing a contract type. Finally, OFPP stated that a decision was recently made, while our report was at OFPP for comment, to make changes to FPDS-NG to eliminate the "combination" contract type as an option for new contracts starting in fiscal year 2010. Modifications made to contracts awarded prior to fiscal year 2010 may still show "combination" as the contract type, as contract type is inherited from the base contract award; however, agencies have the ability to self-correct the contract type selection at any time, and the retroactive contract type selection will flow from the base contract to all modifications.

A final recommendation to OFPP, which was in our draft report, has been removed based on new information. This recommendation had to with obligations coded as "other" contract type in fiscal year 2009. OFPP stated that agencies are prevented from selecting "other" as a contract type for new procurements awarded after September 30, 2008, but that this contract type may still occur on modifications made after that date. We analyzed fiscal year 2009 FPDS-NG information and confirmed that the obligations coded as "other" were modifications to existing contracts. OFPP noted that, as with the "missing" contract type, agencies have the ability to self-correct the "other" contract type on modifications to existing contracts. OFPP stated that it will discuss with agencies the burden

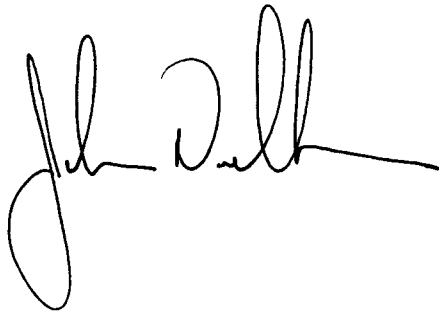
associated with making these changes on a voluntary basis, such as when making modifications to contracts that were recently awarded and may not expire for a number of years.

In written comments, reprinted in appendix II, NASA stated that the report provides a balanced view of the issues related to the use of cost-reimbursement contracts. The Department of Health and Human Services (HHS) also provided written comments, included in appendix III, agreeing with our recommendation directed to it. HHS stated that, in response to our findings, the Office of Acquisition Management and Policy issued a departmentwide notice to remind contracting staff of the need to ensure the adequacy of contractors' accounting systems before award of a cost-reimbursement contract. HHS also stated that it would emphasize the importance of documenting the basis for cost-reimbursement contracts in acquisition plans and further encourage contracting officers to assess the viability of transitioning from cost-reimbursement contracts to more definite contract types. Finally, HHS provided additional information on AHRQ's contract for its annual Medical Expenditure Panel Survey.

The Departments of Defense, Energy, and Treasury provided technical comments which we incorporated as appropriate. The Environmental Protection Agency, NSF, and the Corporation for National and Community Service had no comments on the report.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the report date. We will then send copies of this report to interested congressional committees; the Secretaries of Defense, Energy, Health and Human Services, and the Treasury; the Administrators of the Environmental Protection Agency, NASA, and OFPP; the Director of NSF; and the Chief Executive Officer of the Corporation for National and Community Service. The report also will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report or need additional information, please contact me at (202) 512-4841 or needhamjk1@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Staff acknowledgments are provided in appendix IV.

A handwritten signature in black ink, appearing to read "John K. Needham". The signature is fluid and cursive, with a large initial "J" and "N".

John K. Needham, Director
Acquisition and Sourcing Management

Appendix I: Scope and Methodology

To determine the extent to which federal agencies are using cost-reimbursement contracts, we extracted and analyzed, from the Federal Procurement Data System-Next Generation (FPDS-NG), cost-reimbursement coded contract actions and dollars obligated by agencies for fiscal years 2003 to 2007. In some cases, agency data are reported to FPDS-NG at component levels; in other cases, the entire agency reports as a whole. We also extracted and analyzed from FPDS-NG contract actions coded as “combination,” “other,” and “missing” for fiscal years 1999 through 2008.

To determine what agencies are buying using cost-reimbursement contracts, we analyzed FPDS-NG data for fiscal year 2008. We also analyzed the statements of work for the contracts and orders in our sample.

To determine agencies’ rationales for using cost-reimbursement contracts, whether contracting officers had deemed contractor accounting systems adequate for determining costs applicable to the contracts, and procedures for surveillance of contractor cost controls, we took the following steps. Based on FPDS-NG data for fiscal year 2007, we grouped the agencies and their components into three categories based on their reported obligations under cost-reimbursement contracts. Category 1 comprises agencies that reported obligating less than 20 percent of their total obligations in fiscal year 2007 under cost-reimbursement contracts. Category 2 comprises agencies with reported cost-reimbursement obligations of 20 to 50 percent. Category 3 comprises agencies with cost-reimbursement obligations of 51 percent and higher. We reviewed the files of 10 randomly selected contracts or orders, with obligations of at least \$1 million, from 5 of the category 2 and 6 of the category 3 agencies, with two exceptions. We reviewed only one contract at the Corporation for National and Community Service and at the Department of the Treasury’s Alcohol and Tobacco Tax and Trade Bureau, as those contracts accounted for the totality of those agencies’ reported cost-reimbursement contracts in fiscal year 2007.

In all, we reviewed 92 contracts or orders at the agencies listed below. Agencies were selected based on location and their reported use of cost-reimbursement procurements.¹

¹ Percentages have been rounded.

- Category 2:
 - Corporation for National and Community Service, Washington, D.C. – 35 percent
 - Department of the Air Force, Aeronautical System Center, Wright-Patterson Air Force Base, Dayton, Ohio – 33 percent
 - Department of the Navy, Navy Strategic Systems Program, Arlington, Virginia – 39 percent
 - Department of the Treasury, Internal Revenue Service, National Procurement Office, Oxon Hill, Maryland – 36 percent
 - Environmental Protection Agency, Cincinnati Procurement Operations Division, Cincinnati, Ohio – 45 percent
- Category 3:
 - Department of Defense, Defense Microelectronics Activity, McClellan, California – 97 percent
 - Department of Health and Human Services, Agency for Healthcare Research and Quality, Rockville, Maryland – 87 percent
 - Department of Energy, multiple sites in several states² – 90 percent
 - Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau, Washington, D.C. – 100 percent
 - National Aeronautics and Space Administration, Glenn Research Center, Cleveland, Ohio – 81 percent
 - National Science Foundation, Arlington, Virginia – 81 percent

Our review of the contract files focused on whether the files contained documentation providing the rationales for awarding cost-reimbursement contracts and evidence that the contractors' accounting systems were adequate for determining costs applicable to their contracts. We also reviewed the sections of the Federal Acquisition Regulation (FAR) and implementing agency policies and regulations that stipulate the requirements that need to be met before a cost-reimbursement contract is to be used. We interviewed a recognized expert from academia with experience with this contract type. To supplement file reviews, we interviewed agency contracting officers, contract specialists, or both to determine how they documented their rationales for awarding cost-reimbursement contracts.

As a data reliability check, for the 11 agencies in our review we also identified cost-reimbursement contracts coded in FPDS-NG as buying

² We did not conduct file reviews at the Department of Energy since there were multiple locations. Program officials provided copies of requested information from contract files.

commercial items. We did this because the FAR prohibits the use of cost-reimbursement contracts to acquire commercial items, as commercial items can be procured with a contract type other than a cost contract on the open market. FPDS-NG reported that 3 of the agencies had at least one cost-reimbursement contract coded as buying a commercial item. For these contracts, we obtained explanations for the coding from agency officials. In all cases, agency officials explained, to our satisfaction, that the coding was in error. For example, FPDS-NG showed that 12 cost-reimbursement contracts at the Air Force's Aeronautical System Center were used to procure commercial items. Center officials explained that the coding was incorrect because of a glitch in the implementation of a new computerized contract writing system, which has subsequently been corrected. A review of the contracts showed that they should have been coded as fixed-price or time-and-materials contracts, not cost-reimbursement contracts, as reported to FPDS-NG.

Further, we conducted interviews with agency procurement policy representatives and heads of contracting activities for 10 agencies with very high reported use (95 percent or more) of fixed-price contracts to determine the reasons for their low use of cost-reimbursement contracts. One of the agencies that we identified as having reported a high use of fixed-price contracts in fiscal year 2007, the Department of Justice's U.S. Marshals Service, was dropped from this part of our review because we found that many of its contracts had been miscoded. Although the U.S. Marshals Service had reported 95 percent of its obligations as fixed price, discussions with contracting officials revealed that many of their obligations should have been coded as labor-hour contracts and not as fixed-price contracts. U.S. Marshals Service officials told us that they have taken steps to correct these coding errors in FPDS-NG.

The remaining nine agencies, together with the percentage of their fiscal year 2007 obligations using fixed-price contracts, are presented below.

- Court Services and Offender Supervision Agency, Pretrial Services Agency, Washington, D.C. – 99.8 percent
- Department of Agriculture, Agricultural Marketing Service, Washington, D.C. – 99.9 percent
- Department of Agriculture, Farm Service Agency, Washington, D.C. – 98 percent
- Department of Agriculture, Agricultural Research Service, Washington, D.C. – 98 percent
- Department of Defense, Defense Commissary Agency, Fort Lee, Virginia – 100 percent

-
- Department of Defense, Defense Logistics Agency, Fort Belvoir, Virginia – 98 percent
 - Department of the Interior, Office of Surface Mining Reclamation and Enforcement, Washington, D.C. – 97 percent
 - Department of Justice, Federal Prison System, Washington, D.C. – 97 percent
 - General Services Administration, Public Buildings Service, Washington, D.C. – 98 percent

Finally, to identify agencies' procedures for surveillance of contractor costs, we reviewed contract files and documents maintained by surveillance officials for each contract and order in our review. We also reviewed agency cost surveillance procedures, relevant parts of the Defense Contract Audit Agency's contract audit manual and our *Cost Estimating and Assessment Guide*,³ which provides information on practices for ensuring credible cost estimating, including earned value management. In addition, we interviewed contracting officers and the personnel responsible for the surveillance.

Where appropriate, we supplemented our analysis with reviews of prior GAO reports, agency inspector general reports, and recent statutory and regulatory actions pertaining to cost-reimbursement contracts.

We conducted this performance audit from July 2008 to September 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

³ GAO, *GAO Cost Estimating and Assessment Guide: Best Practices for Developing and Managing Capital Program Costs*, [GAO-09-3SP](#) (Washington, D.C.: March 2009).

Appendix II: Comments from the National Aeronautics and Space Administration

National Aeronautics and
Space Administration
Headquarters
Washington, DC 20546-0001



September 17, 2009

Reply to Attn of:

Office of Procurement

Mr. John K. Needham
Director, Acquisition and Sourcing Management
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Needham:

Thank you for the opportunity to review the Government Accountability Office (GAO) draft report entitled, "Contract Management: Extent of Federal Spending under Cost-Reimbursement Contracts Unclear and Key Controls Not Always Used," (GAO-09-921).

We found the draft report to be complete, concise, and accurate. In our opinion, the draft report provides a balanced view of the issues related to use of cost-reimbursement contracts. We have not provided technical comments to the draft report.

Again, thank you for the opportunity to provide comments on the draft report and for your continued interest in the use of cost-reimbursement contracts.

Sincerely,


William P. McNally
Assistant Administrator for Procurement

Appendix III: Comments from the Department of Health & Human Services



DEPARTMENT OF HEALTH & HUMAN SERVICES

OFFICE OF THE SECRETARY

Assistant Secretary for Legislation
Washington, DC 20201

SEP 24 2009

John P. Hutton
Director, Acquisition and Sourcing Management
U.S. Government Accountability Office
441 G Street NW
Washington, DC 20548

Dear Mr. Hutton:

Enclosed are the Department's comments on the U.S. Government Accountability Office's (GAO) draft report entitled: Contract Management: Extent of Federal Spending under Cost-Reimbursement Contracts Unclear and Key Controls Not Always Used (GAO-09-921).

The Department appreciates the opportunity to review and comment on this draft report before its publication.

Sincerely,

A handwritten signature in black ink, appearing to read "Andrea Palm", written over a horizontal line.

Andrea Palm
Acting Assistant Secretary for Legislation

Enclosure

GENERAL COMMENTS OF THE DEPARTMENT OF U.S. HEALTH AND HUMAN SERVICES (HHS) ON THE GOVERNMENT ACCOUNTABILITY OFFICE'S (GAO) DRAFT REPORT ENTITLED, CONTRACT MANAGEMENT: EXTENT OF FEDERAL SPENDING UNDER COST-REIMBURSEMENT CONTRACTS UNCLEAR AND KEY CONTROLS NOT ALWAYS USED (GAO-09-921)

In response to the recommendation that the Secretary of Health and Human Services direct the Director of the Agency for Healthcare and Research Quality (AHRQ) to provide guidance to the agency's contracting staff to ensure that they are aware of their responsibility to ensure that the contractors' accounting systems have been deemed adequate before awarding cost-reimbursement contracts, the Department of Health and Human Services (HHS) has the following response:

As a result of the GAO review, the Office of Acquisition Management and Policy issued a Department-wide notice to remind HHS contracting staff of the need to ensure the adequacy of the contractors' accounting systems prior to award of a cost-reimbursement contract. This reminder addressed the acquisition regulation, contract audit guidance and best practices regarding the determination of the adequacy of contractors' accounting systems. The Acting AHRQ Head of Contracting Activity further disseminated and emphasized the importance of this guidance to AHRQ contracting personnel.

HHS will continue to focus attention on GAO findings and share successful practices at our quarterly Executive Committee for Acquisition (ECA) meetings and incorporate compliance with the requirements of Federal Acquisition Regulation Part 16.301, Limitations regarding the use of Cost-Reimbursement Contracts, in our Procurement Management Review protocols.

In addition, HHS will continue to emphasize the importance of documenting the basis for the contract type in its Acquisition Plans; this requirement is consistent with our current Acquisition Plan guidance.

HHS contracting officers are further encouraged to consider and assess the viability of transitioning from cost-reimbursement contracts to a more definite contract type. With assistance from program and technical personnel, requirements can be separated and defined into specific, measurable deliverables and firmer requirements. AHRQ's contracting office has reported that they have successfully transitioned many of their contracts to fixed-price type contracts as a result of such assistance.

HHS appreciates this opportunity to also address the AHRQ contract for annual Medical Expenditure Panel Survey (MEPS) referenced in the report. Although the surveys have been performed since 1996, this is a set of complex, large scale surveys with families and individuals, their medical providers and employers across the United States. While the surveys are an ongoing requirement, the dynamics of the surveys are constantly changing due to their dependence on the National Health Interview Survey, which directly affects the field work structure, pricing and degree of statistical effort which is often not known until after award of the contract. Additional information is provided in the Attachment.

GENERAL COMMENTS OF THE DEPARTMENT OF U.S. HEALTH AND HUMAN SERVICES (HHS) ON THE GOVERNMENT ACCOUNTABILITY OFFICE'S (GAO) DRAFT REPORT ENTITLED, CONTRACT MANAGEMENT: EXTENT OF FEDERAL SPENDING UNDER COST-REIMBURSEMENT CONTRACTS UNCLEAR AND KEY CONTROLS NOT ALWAYS USED (GAO-09-921)

The National Medical Expenditure Survey (NMES) is a complex set of large scale surveys of families and individuals, their medical providers, and employers across the U.S. While it is an ongoing requirement, the dynamics of the survey constantly change. These changes, which can not always be identified at the time of the requirement, greatly influence the contract type and impact the overall performance. Consequently, the use of a cost-reimbursement contract best enables the government the flexibility to contractually adjust for these impacts.

Since its initiation the Medical Expenditure Panel Survey (MEPS) has changed and expanded to provide more timely information about the nation's health care system or to comply with AHRQ's reauthorization legislation. A new panel or sample of households is introduced into the survey every year.

MEPS has 2 major components: the Household Component (HC) and the Insurance Component (IC). The HC collects detailed information from each person in a household drawn from a sample of families and individuals in selected communities nationwide. The information includes demographic characteristics, health conditions, health status, use of medical services, charges and source of payments, access to care, satisfaction with care, health insurance coverage, income, and employment. Interviews cover two full years; this data enables AHRQ to determine how changes in respondents' health status, income, employment, eligibility for public/private insurance coverage, use of services, and payment for care are related.

MEPS-HC households are a sub-sample of households that participate in the National Health Interview Survey (NHIS) conducted by the National Center for Health Statistics approximately six months prior to MEPS. Changes in the NHIS directly affect the field work structure, pricing, and degree of statistical effort required for MEPS; however, these changes are often not known until after award of the contract.

The IC collects data from a sample of private and public sector employers on the health insurance plans they offer their employees. The information includes the number and types of private insurance plans offered (if any), premiums, contributions by employers and employees, eligibility requirements, benefits associated with these plans, and employer characteristics.

The information collected during these surveys is always subject to data element changes that result from geographical relocations and survey mortality rates.

Given the history of MEPS, and AHRQ's mission to provide the most comprehensive data on the cost and use of health care and health insurance coverage, it is critical that the a Contractor have a thorough understanding of MEPS, NHIS, statistical survey practices and methodology, and human subjects regulations.

GENERAL COMMENTS OF THE DEPARTMENT OF U.S. HEALTH AND HUMAN SERVICES (HHS) ON THE GOVERNMENT ACCOUNTABILITY OFFICE'S (GAO) DRAFT REPORT ENTITLED, CONTRACT MANAGEMENT: EXTENT OF FEDERAL SPENDING UNDER COST-REIMBURSEMENT CONTRACTS UNCLEAR AND KEY CONTROLS NOT ALWAYS USED (GAO-09-921)

Without this knowledge, which is gained only through experience with the requirement, the contractor may not understand that in order to ensure responses at the required rate level ample field resources must be provided. The Contractor must also develop a custom designed computerized application process capable of capturing high response rates from survey respondents.

In an effort to encourage competition, AHRQ issued an RFI for both the 2002 and 2008 procurements. While no responses were received for the 2002 request, AHRQ did successfully award part of the effort to a new contractor in 2008. Due to the dynamic nature of the requirement, it was noted by both AHRQ program and contracting staff that this would have been unlikely in a fixed-priced environment. AHRQ will continue to carefully explore opportunities for competition, and the use of alternate contract types, if only on a portion of the effort, in its mission to provide reliable and valid information on the overall health and wellbeing of the Nation.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

John K. Needham (202) 512-5274 or needhamjk1@gao.gov

Acknowledgments

In addition to the contact named above, Michele Mackin, Assistant Director; Julie Hadley; Daniel Hauser; Julia Kennon; LeAnna Parkey; Kenneth Patton; Matthew Shaffer; and Sylvia Schatz made key contributions to this report.

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