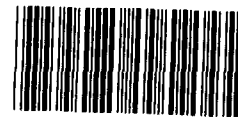


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Inadequate Controls Over DOD
Subcontracts Cost Government
Millions of Dollars

Statement of
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Before the
Committee on Governmental Affairs
United States Senate



Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss GAO's work on Department of Defense (DOD) subcontracts. As you know, we have identified several areas in which weaknesses in federal agencies' internal controls and management information and accounting systems have created a high risk for major losses of federal funds and for incidents of collateral fraud and abuse. Defense acquisition is one of these "high risk" areas. In the area of defense acquisition, we have made a special audit effort to assess whether DOD is vulnerable to inflated subcontract prices.

In response to your request, we have issued several reports (see attachment I) demonstrating that defense subcontract pricing is a high risk. Our work shows that DOD's prime contract prices are inflated by hundreds of millions of dollars annually because

- subcontractor overpricing is frequent and pervasive;
- subcontract cost-estimating problems are chronic and widespread; and
- so-called "competitive" subcontract prices are often overstated.

Before discussing each of these areas, let me explain the importance of effective management controls in defense subcontracting.

GROWING IMPORTANCE OF SUBCONTRACTS IN DOD PROCUREMENTS

In the past several decades, the changing role of many prime contractors from fabricating weapons and products to integrating work done by subcontractors has resulted in a substantial increase in subcontracting activities. Today, subcontract costs

frequently comprise more than 50 percent of prime contract costs. According to DOD reports, subcontracts awarded in fiscal year 1990 totaled about \$55 billion--a sum larger than the combined budget authority of the Departments of Transportation (\$30.2 billion), Energy (\$14 billion), and Interior (\$6.7 billion).

Because of DOD's growing dependence on subcontractors, subcontract prices are critical in the negotiation of contracts. However, DOD does not have direct management control over subcontracts because its contractual relationship is with the prime contractors, not the subcontractors. DOD relies, to a great extent, on prime contractors to negotiate fair and reasonable subcontract prices. As a result, there is a need for DOD to ensure that contractors have adequate systems and procedures to preclude inflated subcontract estimates from being negotiated in contract prices.

SUBCONTRACT OVERPRICING IS FREQUENT AND PERVASIVE

The extent of subcontractor overpricing is unknown because only a limited number of subcontracts are audited. Our analysis showed that subcontractors frequently did not disclose accurate, complete, and current cost or pricing data as required by the Truth in Negotiations Act. Such nondisclosures cost DOD hundreds of millions of dollars annually. The pervasiveness of subcontractor overpricing is alarming and, as discussed later, DOD does not have sufficient audit resources to ferret out all noncompliance.

The prices of many defense items are determined through extensive negotiations because there may be only one supplier producing limited quantities of highly complex and specialized, one-of-a-kind products. Recognizing the government's vulnerability to inflated contract prices, Congress passed the Truth in Negotiations Act in 1962. The act requires prime contractors and

subcontractors to submit data supporting their proposed prices and to certify that the submitted data are accurate, complete, and current.

Defective pricing occurs when negotiated contract prices are higher than warranted due to either prime contractors' or subcontractors' failure to disclose accurate, complete, and current cost or pricing data. When defective pricing is found, the act provides the government with a legal basis to recover inflated contract prices.

Within DOD, the Defense Contract Audit Agency (DCAA) is responsible for conducting audits to determine whether contractors comply with the act. Accordingly, DCAA provides an important internal control within the DOD procurement process. The results of DCAA defective pricing audits are tracked individually in DOD's audit followup system. However, DCAA audit results are not analyzed or summarized to differentiate between prime contractor and subcontractor defective pricing or to identify whether systemic weaknesses exist in the way subcontracts are priced.

We, therefore, analyzed and summarized the results of 8,333 DCAA defective pricing audits conducted in fiscal years 1987 through 1990. Of the total, 6,267 audits addressed prime contractors' compliance with the act and 2,066 audits covered subcontractors' compliance. Our analysis of the 2,066 reports shows that subcontractors' noncompliance with the Truth in Negotiations Act is widespread and causes contract prices to be significantly overstated.

Specifically, we found that 43 percent of the 2,066 subcontract audits identified defective pricing. Subcontractor defective pricing reported during the 4-year period totaled \$880 million--an average of about \$1 million for each defectively-priced

subcontract. We also found that subcontract defective pricing occurs slightly more frequently than does prime contract defective pricing -- 43 percent of the 2,066 audits versus 41 percent of the 6,267 audits, respectively -- and more frequently at contractor locations where DCAA does not maintain resident staffs.

Because of the numbers, DCAA cannot audit all contracts and subcontracts subject to the Truth in Negotiations Act. Although the universe of subcontracts subject to the act is unknown, the number is significant. For example, in fiscal year 1990, DOD had 37,311 prime contract actions subject to the act. The number of subcontracts awarded under those prime contracts would be appreciably greater.

DCAA has competing demands on available resources which result in it selecting contracts and subcontracts to be audited based on an assessment of contractor risk. However, even for high risk contractors, such as those with chronic estimating deficiencies and a high incidence of defective pricing, DCAA plans to audit only 1 in 10 contracts worth between \$1 million and \$10 million and only 1 in 50 contracts worth between \$100,000¹ and \$1 million.

SUBCONTRACT ESTIMATING DEFICIENCIES
ARE WIDESPREAD AND CHRONIC

Recognizing that it is neither desirable nor practical to audit each and every contract and subcontract subject to the Truth in Negotiations Act, we believe the key to protecting the government's interest is to ensure that contractors have estimating systems that produce reliable contract proposals

¹The 1991 Defense Authorization Act raised the dollar threshold for contracts that require the submission of cost or pricing data to \$500,000.

supported by accurate, complete, and current data. It is important to note that when poor estimating causes contract prices to be overstated, the government may not have a safeguard, such as the Truth in Negotiations Act, for reducing the inflated contract prices.

In March 1988, in response to contract pricing abuses identified by us and the DOD Inspector General, DOD revised its procurement regulations to require major contractors to establish and maintain cost-estimating systems that produce supportable and verifiable contract proposals. According to DOD officials, the regulatory revision is the "most significant action" recently taken by DOD to ensure fair and reasonable contract prices and address problems with subcontract pricing.

We agree the regulatory revision is significant in that, for the first time, administrative contracting officers have been authorized to disapprove contractors' systems if they are found to be unacceptable. More importantly, the regulatory revision gives administrative contracting officers the authority to take whatever action is determined necessary to ensure that contractors correct unacceptable systems. For example, administrative contracting officers can reduce or suspend progress payments or recommend that contracts not be awarded.

Despite the regulatory revision, however, we found that prime contractor estimating deficiencies relating to subcontracts continue to be widespread and chronic. Based on our review of 101 contractor estimating system reports issued by DCAA, 83 contractors had estimating deficiencies relating to subcontracts that needed to be corrected. Forty-two had problems so serious that DCAA considered the companies' systems to be unacceptable for negotiating fair and reasonable prices. These 42 contractors had fiscal year 1989 sales to DOD of about \$11.3 billion. Sixty-four of the 83 contractors had not corrected deficiencies

identified by DCAA in previous audits. The deficiencies, on average, had remained uncorrected about 17 months. We found no instance where administrative contracting officers used the sanctions provided in DOD regulations to ensure timely contractor corrective action.

Inadequate Evaluations of Noncompetitive Subcontracts Often Lead to Inflated Contract Prices

One of the prevalent subcontract estimating problems relates to prime contractors' failure to evaluate noncompetitive subcontractor proposals. Prior DOD audits and reviews by our office have shown that shortcomings in this area translate directly into inflated contract prices.

As a safeguard against inflated subcontract prices, DOD regulations require contractors to evaluate noncompetitive subcontracts and include the results of the evaluations as part of their contract proposals. The key here is that such evaluations should be made before DOD and the contractor agree to a contract price because the evaluations can provide contracting officers with a basis for ensuring that only fair and reasonable subcontract estimates are priced into contracts.

In past reviews, we and the DOD Inspector General have found that when contractors failed to evaluate noncompetitive subcontractor proposals, DOD's contract prices were inflated by millions of dollars. In response to evidence of such subcontracting abuses, DOD issued several policy memoranda emphasizing the need to obtain subcontract evaluations and to use them in negotiating prime contract prices. DOD's March 1988 estimating system regulation also specified that a contractor's continued failure to evaluate subcontractors' proposals was sufficient reason to disapprove a contractor's estimating system.

Despite DOD's efforts to strengthen its regulations and to increase its emphasis on problems with subcontract pricing, DOD's contract prices continue to be overstated because of prime contractors' failure to perform subcontract evaluations. In addition to reviewing DCAA's estimating system reports, we evaluated subcontract prices negotiated in four recently awarded DOD contracts. We found that contractors reaped windfalls of about \$9 million on the four contracts primarily because they had not completed noncompetitive subcontract evaluations prior to DOD's contract negotiations.

Let me explain how these windfalls occur. On one of the contracts we reviewed, the contractor had not performed the required evaluations of five subcontractor proposals. Instead, the contractor had made preliminary evaluations of four of the subcontractors' proposals and recommended reductions ranging from 1 to 5 percent. No evaluation was made of the fifth proposal. In its preliminary analyses, the contractor pointed out that its evaluations were based on limited data and should not be used to undertake negotiations with subcontractors. In negotiations, the DOD contracting officer was able to reduce the proposed subcontract prices.

However, after contract negotiations with DOD, the contractor conducted in-depth evaluations of revised subcontract proposals and recommended reductions ranging from 8 to 27 percent. Using the in-depth evaluations, the contractor negotiated subcontract prices that were about \$3 million below the subcontract prices negotiated in the contract with DOD. DOD received no benefit from the reductions. This situation is typical of many that we and DOD audit agencies have reported over the last several years.

COMPETITIVE SUBCONTRACT
PRICES ARE OFTEN OVERSTATED

Our work also shows that DOD has not realized the full benefits to be gained through competition. We found that subcontract prices actually paid by prime contractors were lower than the competitive subcontract prices included in prime contractors' proposals and negotiated contract prices. In other words, prime contractors used one set of competitive subcontract prices to support their proposals to the government but subsequently solicited and obtained significantly lower prices for negotiating their subcontracts.

Prior GAO and DOD audits show that this practice costs DOD millions of dollars. Two of our recent reviews showed that prime contractors awarded their competitive subcontracts for about \$12 million, or eight percent less than the amounts included in DOD contracts.

This situation is particularly disturbing because competition is the preferred method of government contracting. In a competitive environment, pricing safeguards are not used because it is presumed that marketplace forces will produce fair and reasonable prices. Our work shows that contracting officers, acting on this belief, generally accepted competitive subcontract prices included in contractor proposals without question. It is not reasonable, however, for DOD contracting officers to accept representations of competitive subcontract prices when contractors routinely solicit and obtain significant reductions in the prices they include in their proposals to the government.

CORRECTIVE ACTIONS ARE NEEDED
TO ADDRESS LONG-STANDING PROBLEMS

The collective results of our work, and that of other audit agencies, demonstrate that defense subcontract pricing is a high risk area--it is highly vulnerable to fraud, waste, and abuse. Despite DOD's efforts to strengthen its regulations on cost-estimating systems and to increase its emphasis on subcontract pricing, DOD continues to be plagued with persistent and widespread problems costing the Department and American taxpayers hundreds of millions of dollars annually.

These conditions are unacceptable. Until well-known, fundamental defects in contractors' cost-estimating systems and other abuses are corrected, inflated subcontract estimates will continue to find their way into prime contract prices. We believe that DOD needs to take more forceful and effective action to deal with contractors that display chronic estimating deficiencies and a high incidence of defective pricing.

Our reports contain several recommendations to deal with the problems I have discussed here today. We are not recommending more regulations. We believe existing laws and regulations provide a sound framework for dealing with the problems. The regulations include strong sanctions contracting officers should be using to protect the government's interests until the deficiencies are corrected. These include reducing or suspending progress payments, utilizing contract savings clauses, and delaying or not awarding contracts. We believe that more effective use of these tools is absolutely essential to improving subcontract prices and reducing DOD contract costs by hundreds of millions of dollars annually.

In view of the magnitude and seriousness of the problems we identified, we also believe the Secretary of Defense should

designate subcontract pricing as a material internal management control weakness in accordance with the Federal Manager's Financial Integrity Act of 1982. Such a designation would bring high level management attention to the problem and should increase accountability of DOD managers and motivate them to establish or strengthen controls in an area where significant contract overpricing occurs.

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Mr. Chairman, that completes my statement. I will be pleased to answer any questions you or the members may have.

Contract Pricing: Subcontract Defective Pricing Audits (GAO/NSIAD-91-148FS, March 21, 1991).

Contract Pricing: Competitive Subcontract Price Estimates Often Overstated (GAO/NSIAD-91-149, March 20, 1991).

Contract Pricing: Defense Subcontract Cost-Estimating Problems Are Chronic and Widespread (GAO/NSIAD-91-157, Mar. 28, 1991).

Contract Pricing: Inadequate Subcontract Evaluations Often Lead to Higher Government Costs (GAO/NSIAD-91-161, April 5, 1991).