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Report to the Secretary of Defense

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CONTRACT PRICING

Economy and Efficiency Audits Can Help Reduce Overhead Costs

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GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-219741

October 30, 1991

The Honorable Richard B. Cheney
The Secretary of Defense

Dear Mr. Secretary:

According to the Department of Defense (DOD), overhead costs represent roughly one-third of the price that DOD pays for its weapon systems. In 1984, the Deputy Secretary of Defense emphasized the need for DOD to reduce overhead costs by using evaluation tools such as overhead should-cost reviews, cost-monitoring reviews, and operations audits, each of which measures the economy and efficiency of contractors' operations.

We have completed our review of these three analytical tools. Our objective was to determine the extent to which DOD used them to evaluate the economy and efficiency of contractors' overhead costs.

Results in Brief

DOD's use of overhead should-cost reviews, cost-monitoring reviews, and operations audits has decreased to the point that the agency's efforts no longer reflect the Deputy Secretary of Defense's emphasis on the importance of these analytical tools. Specifically,

- the number of overhead should-cost reviews decreased since 1985, while the number of less comprehensive "in-depth" reviews increased;
- the number of cost-monitoring reviews of overhead costs conducted at the nine contractor sites we visited decreased by over 50 percent from 1987 to 1990; and
- the number of operations audits of overhead costs performed at the nine contractors we visited decreased by over one-third from 1985 to 1990.

Although these analytical tools have identified significant unnecessary overhead costs, DOD officials said that they had not sustained their review effort because of inadequate staffing or a shift in emphasis to other types of work. At the same time, overhead rates may continue to increase, as they have since 1987, if the cost of DOD acquisitions continues to decline in the 1990s. Unless there is a renewed emphasis by DOD, these reviews may decline further as DOD's acquisition work force is reduced.

Background

Overhead costs, also called indirect costs, benefit more than one contract and must be allocated to contracts on some reasonable basis. The costs of facilities and equipment, general office support, computer operations, supervisors' salaries, and security are typically classified as overhead because they are not directly assignable to a specific contract.

In December 1984, the Deputy Secretary of Defense announced a program to improve DOD's oversight of contractors' overhead and ultimately lead to reductions in overhead costs. The program responded to DOD's concern that inadequate management attention and surveillance of contractors' overhead costs may have allowed defense contractors to charge improper or excessive overhead costs to DOD contracts.

As part of the program, the Deputy Secretary emphasized the importance of avoiding pricing methods that placed undue emphasis on historical costs. Instead, the Deputy Secretary stated that DOD must use evaluation tools such as should-cost, cost monitoring reviews, and operations audits to the fullest extent.

Decrease in the Use of Overhead Should-Cost Reviews

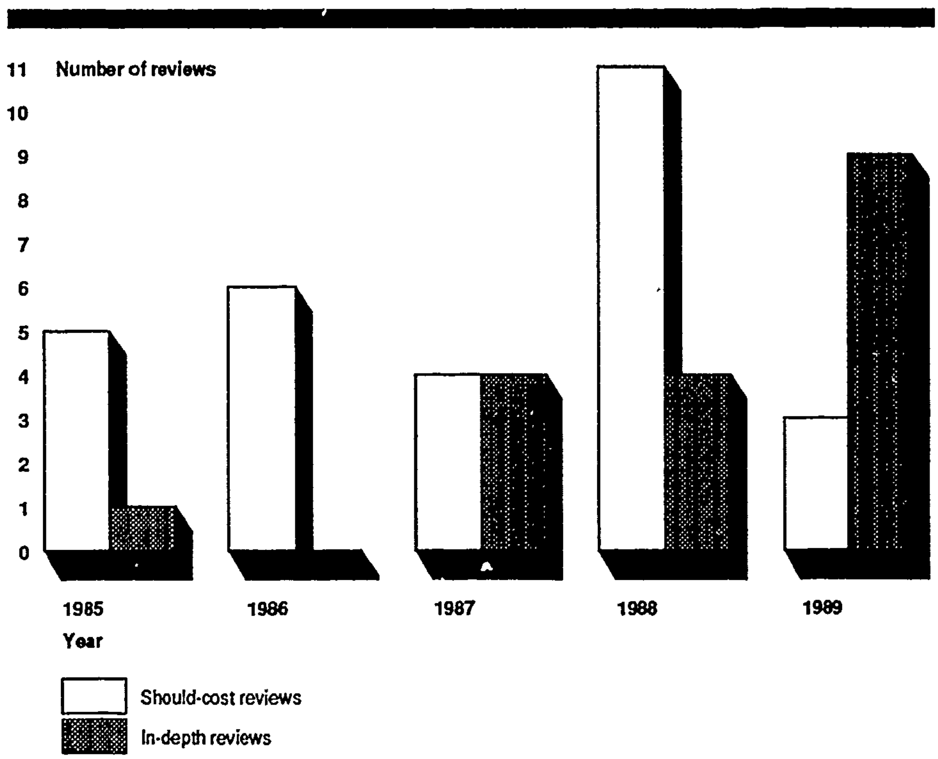
Overhead should-cost reviews are a specialized form of cost analysis that differs from DOD's traditional evaluation methods. During traditional reviews, local contract audit and contract administration personnel primarily base their evaluation of forecasted expenses on an evaluation of historical costs and trends. In contrast, overhead should-cost reviews do not assume that a contractor's historical costs reflect efficient and economical operations. Instead, these reviews evaluate the economy and efficiency of the contractor's existing work force, methods, materials, facilities, operating systems, and management. The reviews use an integrated team of DOD contracting, contract administration, pricing, audit, and engineering representatives. These representatives conduct a comprehensive evaluation of overhead costs to identify both short- and long-range improvements that need to be made to improve the economy and efficiency of a contractor's operations.

As one of the initial steps in DOD's program to reduce overhead costs, the Deputy Secretary directed the Army, Navy, Air Force, and the Defense Logistics Agency (DLA) to each perform at least one overhead should-cost review during fiscal years 1985, 1986, and 1987.[1] However, absent additional DOD-level direction, the military services stopped conducting

[1] In 1990, the separate contract administration organizations of the Air Force, Army, Navy, and DLA were consolidated into the Defense Contract Management Command within DLA.

the reviews after fiscal year 1988. Although DLA has continued to perform overhead should-cost reviews, the agency has relied increasingly on "in-depth reviews" to evaluate contractors' proposed overhead costs. Figure 1 compares the number of overhead should-cost reviews with the number of in-depth reviews conducted by the military services and DLA between 1985 and 1989.

Figure 1: Number of Overhead Should-Cost and In-Depth Reviews Completed by DLA and the Military Services (1985-89)



Source: GAO analysis of DOD data.

Like overhead should-cost reviews, in-depth reviews evaluate the economy and efficiency of a contractor's operations. However, in-depth reviews do not approach the depth of coverage or resources used in overhead should-cost reviews. For example, overhead should-cost reviews employ integrated teams of government contracting, contract administration, pricing, audit, and engineering representatives from local audit and contract administration offices as well as personnel from DOD purchasing offices and regional or headquarter audit and contract administration offices. In-depth teams, on the other hand, are normally limited to local Defense Contract Audit Agency (DCAA) and contract administration personnel. Moreover, overhead should-cost review teams average 36 staff, over three times more than the in-depth review teams.

DOD officials cited a variety of reasons for the decline in overhead should-cost reviews. For example, the officials cited inadequate travel funds and nonavailability of personnel from DOD buying activities and regional or headquarters audit and contract administration offices. However, while citing these problems, the officials also acknowledged that overhead should-cost reviews resulted in significant savings to the government. Our work shows that the potential benefits of conducting overhead should-cost reviews far exceed the additional costs involved in providing personnel and travel funds to conduct the reviews.

Results of Forward-Pricing Rate Agreement Negotiations

Overhead should-cost reviews provide DOD contracting officers a basis for negotiating "forward-pricing rate agreements." Forward-pricing rate agreements are written agreements between contractors and DOD to use certain overhead rates in the negotiation of contracts or contract modifications over a specified period of time. The agreements, used where the volume of negotiated contracting is significant, eliminate the need to negotiate separate overhead rates for each contract or contract modification.

DOD assessments indicate that overhead should-cost reviews were successful and resulted in significant savings for DOD. For example, during their briefing to the Deputy Secretary of Defense, the military services and DLA estimated that the five overhead should-cost reviews completed in fiscal year 1985 saved $1.1 billion compared with government and contractor costs to conduct the reviews of about $2.4 million.

Similar successes were noted in fiscal years 1986 and 1987. For example, in four Air Force overhead should-cost reviews, contracting officers used the review results to reduce contractors' proposed overhead costs by $2.4 billion. According to the Air Force, the reductions were about twice those contracting officers had achieved in prior overhead negotiations when traditional evaluation techniques were used.

DOD and DLA officials told us that they continued to believe that overhead should-cost reviews helped eliminate unnecessary overhead costs from contractor proposals. This view was confirmed by local officials at the five plant representative offices we visited. The local officials stated that the use of overhead should-cost reviews resulted in the negotiation of better forward-pricing rates. Local officials attributed this success to the expanded review objective of evaluating the economy and efficiency of contractors' operations as well as to the use of a larger review team, which included personnel with special expertise and representatives from the buying office and headquarters.

To determine whether DOD's initial optimism had validity, we evaluated the results of forward-pricing rate negotiations at 18 contractor locations. At the 12 contractor locations where overhead should-cost reviews were conducted, we found that DOD negotiators reduced contractors' proposed overhead costs by $3.8 billion, or 10.4 percent of the total amount originally proposed. At the six contractors where in-depth reviews were conducted, DOD negotiators reduced the contractors' proposed overhead costs by $107 million, or 4.3 percent of the total amount originally proposed. Detailed information concerning the results of negotiations in which overhead should-cost and in-depth reviews were used are contained in appendixes I and II, respectively.

We also obtained information, at each of the 18 contractor locations, on the results of prior negotiations in which traditional reviews were used to assess overhead costs. When traditional reviews were used at the 18 locations, DOD negotiators reduced the contractors' proposed overhead costs by $1.03 billion, or 4.4 percent of the total amount originally proposed. Detailed information concerning these results are contained in appendix III.

Since the negotiation results are based on different methods of evaluating a contractors' proposed overhead costs, the results may not be directly comparable; they could be affected by many factors other than the type of review used to evaluate the contractor's proposed costs. For example, the negotiations were conducted at different times, business volume varied among contractors, and different personnel participated in the reviews and negotiations. Nonetheless, DOD acknowledges that overhead should-cost reviews have resulted in significant savings, and our analysis supports that the potential for these savings does exist.

Lack of DOD Regulations to Ensure That Overhead Should-Cost Reviews Are Conducted

In directing the military services and DLA to perform overhead should-cost reviews, the Deputy Secretary stated that if the "approach subsequently proves to be viable, then changes will be made to [DOD] regulations." Although DOD's initial assessments indicated that overhead should-cost reviews had proven viable, DOD has not revised its regulations to ensure that the reviews are performed. The military services stopped conducting overhead should-cost reviews in 1988, and DLA, while still conducting these reviews, has relied increasingly on in-depth reviews.

This situation is similar to the problems the DOD Inspector General found during an evaluation of the use of should-cost reviews to assess the cost of contract proposals for major weapon systems. In September 1985, the Inspector General reported a number of inadequacies in DOD's should-cost policy that resulted in the underutilization of should-cost concept to evaluate individual contract proposals. Among other things, the Inspector General concluded that the military departments were given too much latitude in determining when to do should-cost reviews, and there was no DOD-level oversight to ensure that DOD's should-cost policy was effectively implemented.

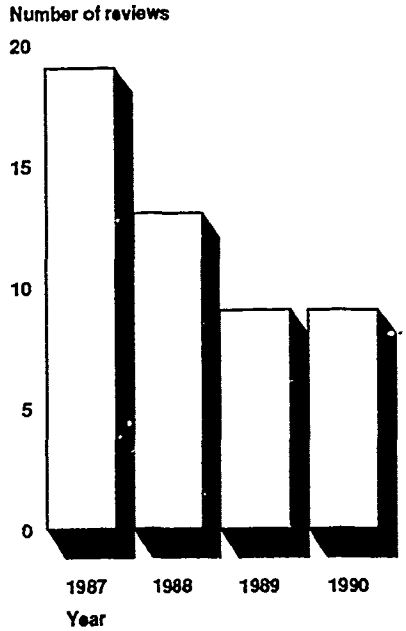
In response to recommendations made by the Inspector General, DOD took a number of actions designed to increase the use of should-cost reviews on individual contracts. For example, in August 1986, a DOD should-cost policy was incorporated into the Defense Federal Acquisition Regulation Supplement. Among other things, the policy established a minimum dollar threshold at which a should-cost review must be performed on an individual contract proposal. The policy also provided criteria for conducting should-cost reviews on individual contract proposals.

Decline in the Use of Cost-Monitoring Reviews

Cost-monitoring reviews, like overhead should-cost reviews, evaluate the economy and efficiency of a contractor's operations. Unlike overhead should-cost reviews, which use a large, multiorganizational staff to review all proposed overhead costs, cost-monitoring reviews are conducted primarily by DLA to evaluate a specific contractor function. For example, the scope of a cost-monitoring review could be limited to evaluating a specific aspect of indirect labor utilization, facilities management, space utilization, equipment disposition, or material receiving and storage. The DLA has identified more than 50 such evaluation areas.

We found that the total number of cost-monitoring reviews involving overhead costs performed at the nine selected contractors we visited had diminished since 1987, as shown in figure 2.

Figure 2: Cost-Monitoring Reviews of Overhead Costs Conducted by DLA at Nine Contractors' Locations (1987-90)



Source: GAO analysis of DOD data.

DOD regulations state that each significant contract operation should be reviewed over a 2- to 3-year period. During the 3-year period ending December 31, 1990, no overhead cost-monitoring reviews were conducted at three of the nine contractors we visited, and four or fewer reviews were conducted at seven of the nine contractors. The cost-monitoring reviews that were conducted were heavily concentrated in the three DLA contractor locations. The remaining six locations, which were run by the three military service contract administration organizations, were consolidated into the DLA's Defense Contract Management Organization in 1990. Detailed information concerning the number of reviews conducted at each contractor location is included in appendix IV.

Local contract administration officials told us that they did not have the resources to perform additional cost-monitoring reviews. These officials also said that such reviews had a lower priority than tasks such as reviewing forward-pricing rate proposals and overhead rate tracking, which are directed at the prices of contracts currently being negotiated.

We recognize that reviewing forward-pricing rate proposals and overhead rate tracking are important activities. However, exclusive of the occasional use of an overhead should-cost review to evaluate a forward-pricing rate proposal, these activities are primarily directed toward using historical costs as a basis for evaluating forecasted expenses. As such, they do not serve as a substitute for cost-monitoring reviews, which determine whether a contractor is managing or using its resources economically and efficiently.

Cost-monitoring reviews have successfully identified and eliminated ineffective or uneconomical contractor practices. For example, the DOD Inspector General reported that cost-monitoring reviews completed at six contractors during 1984 identified $134 million in avoidable costs.[2] At the time of the Inspector General's report, contractors had agreed to corrective actions relating to about $75 million.

More recent cost-monitoring reviews completed at the contractors we visited had also identified unnecessary costs. Two examples of these cost savings follow:

- A 1988 cost-monitoring review estimated that the government saved $49 million because the contractor implemented the review's recommendation to convert computer-generated data and source documents onto microfilm and microfiche.
- A 1989 review estimated that the government could save at least $1.8 million annually if the contractor used in-house labor to conduct the work rather than continue to use job shop labor for extensive periods of time. The contractor agreed to revise its procedures to reduce the use of job shop labor.

Reduction in the Use of Operations Audits

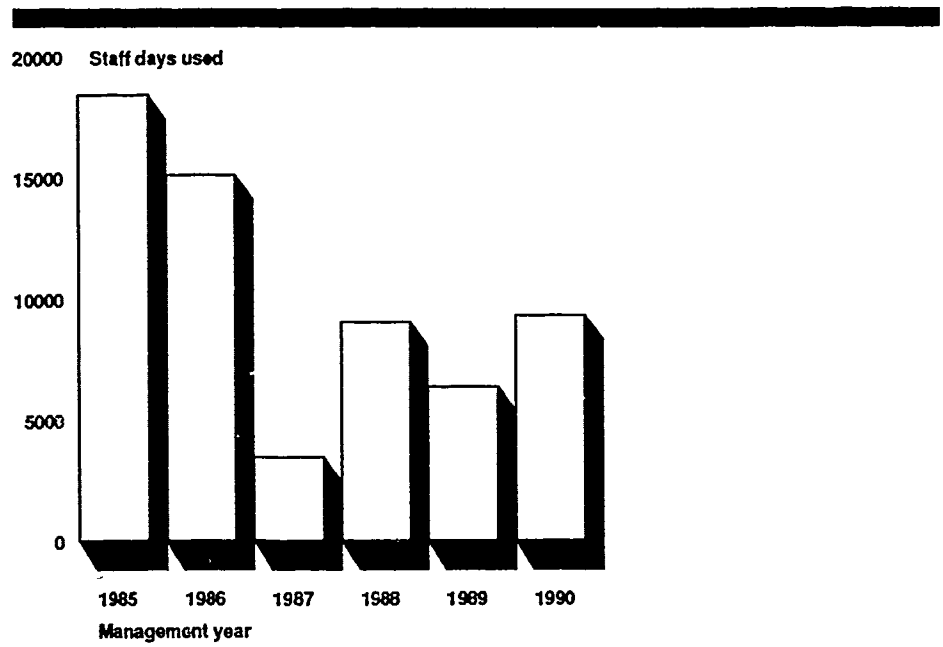
Operations audits, which are conducted by the DCAA, are essentially the same as cost-monitoring reviews conducted by DLA. In this respect, an operations audit evaluates the economy and efficiency of a specific contractor function or operation. The reviews result in recommendations to eliminate unnecessary costs or waste. Recommendations can range from implementing new, emerging technologies to changing existing contractor functions, policies, procedures, or practices.

We found that DCAA had reduced its use of operations audits as a tool to identify unnecessary contractor costs. As shown in figure 3, the number of staff days DCAA spent on operations audits of overhead costs

[2] Report on the Audit of the Effectiveness of Contract Administration Activities in Evaluating and Controlling Contractor Overhead Through Cost Monitoring Program Reviews. (Report No. 87-184, July 1987).

decreased from 18,411 in fiscal year 1985 to 9,300 in fiscal year 1990—a decrease of almost 50 percent. This represents a decline from more than 3 percent of DCAA's direct audit time to less than 1 percent.

Figure 3: Staff Days DCAA Used to Conduct Operations Audits (1985-90)

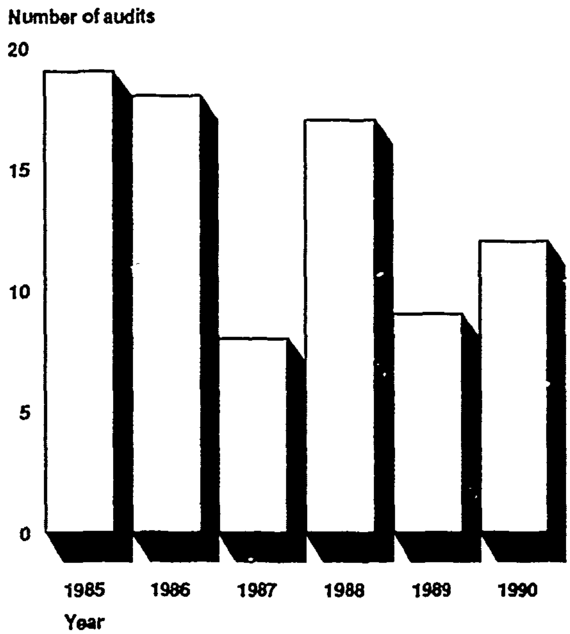


Note: DCAA's 1988 management year was the 15-month period ending September 30, 1988. This change was made to coincide with the federal fiscal year.

Source: GAO analysis of DCAA data.

The decrease in staff days devoted to operations audits was reflected in the number of audits of overhead costs performed at the nine contractors we visited. As shown in figure 4, the number of operations audits of overhead costs conducted by DCAA decreased from 19 in 1985 to 12 in 1990—a decrease of 37 percent. Detailed information on the frequency of these reviews at each location is included as appendix V.

Figure 4: Operations Audits of Overhead Costs Conducted by DCAA at Nine Contractor Facilities (1985-90)



Source: GAO analysis of DOD data.

DCAA officials said that the decreased frequency of operations audits resulted from a shift in audit emphasis from operations audits to other reviews, such as post-award reviews and incurred cost audits. However, DCAA field offices have recognized the need for more operations audits. Between 1985 and 1990, DCAA's annual requirements plans for our nine selected contractors identified a need for 218 operations audits of overhead costs. We found that only 66 (about 30 percent) were conducted in the year planned. Several local DCAA officials told us that fewer operations audits were conducted because of the low priority given to such audits.

Operations audits have successfully identified ineffective or uneconomical contractor practices. For example, the DOD Inspector General reported that DCAA issued 348 operation audit reports that identified avoidable costs of $244.8 million during the 12-month period ending March 30, 1984.[3] On the basis of an analysis of the audits, the Inspector General concluded that operations audits resulted in the implementation

[3]Review of the Defense Contract Audit Agency's Operations Audit Program (APO Report No. 85-007, Dec. 3, 1984).

of more efficient procedures and operations and reduced costs for both contractors and DOD.

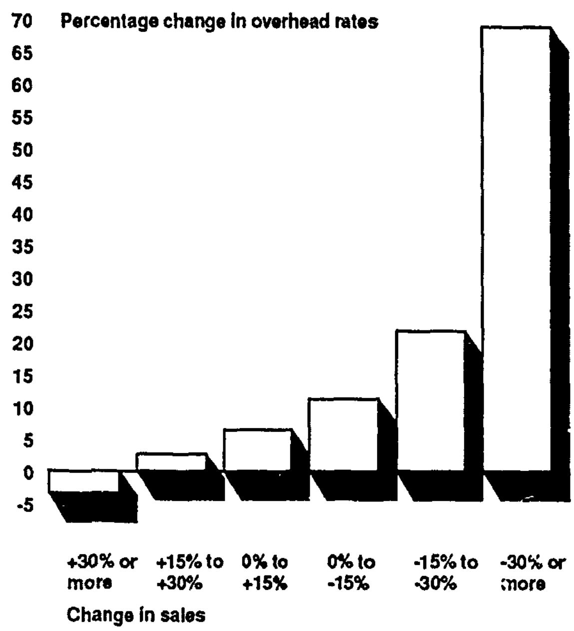
More recent operations audits have continued to result in cost savings. Two examples of this savings follow:

- An operations audit of a major aerospace contractor's health benefit plan saved the government $13.6 million. DCAA recommended changes to the plan including the use of preferred provider plans, mandatory enrollment of first-year employees in a health maintenance organization plan, and the implementation of a mail order drug program. The contractor concurred with the audit recommendations and negotiated the changes into its union agreements.
- An operations audit of a contractor's inventory control system saved the government $5.5 million annually. The review disclosed that inadequate controls resulted in unrecorded quantities, misplaced material, excessive purchases, and inordinate material tracking efforts. The contractor agreed to establish a new inventory control system.

Increase in Overhead Rates With the Decline of Defense Contract Awards

Overhead rates at many major DOD contractors have increased since 1987 as the value of contracts awarded by DOD declined. Prime contract awards decreased from $150.7 billion in 1985 to $129 billion in 1989. At many large contractors, the decrease in their business contributed to increasing overhead rates as remaining DOD contracts were forced to absorb additional overhead costs. Our analysis of the three major overhead rates at 33 contractors showed that 80 percent of the overhead rates increased between 1987 and 1989 regardless of sales changes. Moreover, figure 5 shows that they increased much faster as sales declined.

Figure 5: Average Percentage Change in Overhead Rates Compared With Percentage Change in Sales at 33 Major Contractors (1987-90)



Note: The change in overhead rates is a weighted average of the percentage change in three overhead pools (manufacturing, engineering, and general and administrative overhead) at each of the 33 contractors. Eighteen of the 97 pools (one contractor had only one overhead pool) were not comparable because of accounting changes during the comparison period. Each pool was weighted by its 1987 overhead costs.

Source: GAO analysis of overhead data provided by DCAA.

Higher overhead rates increase contract costs. For example, during the period 1985 to 1989, the overhead rates at one contractor we visited increased by 47 percent for engineering, 83 percent for manufacturing, and 114 percent for general and administrative expenses, when sales to DOD declined after the completion of a major program. The higher overhead rates will be used as the basis for estimating the cost of future contracts and the final cost of existing cost type and flexibly priced contracts.

Planned Work Force Reductions May Further Decrease DOD's Use of Economy and Efficiency Audits

The fiscal year 1991 National Defense Authorization Act requires DOD to cut its acquisition work force by 4 percent each year for the next 5 years. This mandated 20-percent reduction could reduce the acquisition work force by about 107,000 over the 5-year period. The act also mandates similar reduction in DOD management headquarter activities and DOD headquarter support activities. This reduction exemplifies the overall downsizing of DOD operations.

DLA and DCAA staffing levels are being reduced. While the extent of these reductions and their effect on DLA's and DCAA's ability to conduct economy and efficiency reviews is unclear, further decreases in staffing may reduce DOD's ability to conduct economy and efficiency audits. DLA's Defense Contract Management Command reported that its authorized year-end staff level would be reduced by 1,900 (or about 9 percent) during the 2-year period ending September 30, 1993. DCAA reported that its authorized year-end staff would be reduced by over 1,100 (or about 15 percent) in fiscal year 1991. Both organizations may be required to absorb additional staff reductions in the future.

Recommendation

The use of overhead should-cost reviews, cost-monitoring reviews, and operations audits has declined even though DOD could use these analytical tools to identify inefficient and unnecessarily costly contractor operations. Increasing their use to the levels contemplated by the Deputy Secretary of Defense in 1984 could result in identifying significant overhead cost reductions in defense contracts.

We recommend that you

- revise DOD's procurement regulations to provide guidance for the use of overhead should-cost reviews. The regulations should include guidance similar to that currently provided for contract should-cost reviews, including criteria to select review sites.
- direct the Directors of DLA and DCAA to increase the priority of significant cost reduction measures such as overhead should-cost reviews, cost-monitoring reviews, and operations audits.

Agency Comments and Our Evaluation

We submitted a draft of this report to DOD for its review and comment. DOD generally agreed with the information and conclusions included in the report; the Department stated that it agreed with our recommendation to revise the DOD procurement regulations to provide guidance for the use of overhead should-cost reviews. In addition, within the next 90 days, the Office of the Director, Defense Procurement, will issue guidance encouraging the use of overhead should-cost reviews when appropriate.

Regarding our recommendation to increase the priority of significant cost reduction measures, we believe that DOD's agreed to actions will encourage the expanded use of overhead should-cost reviews. In addition, DLA's Defense Contract Management Command is currently evaluating its cost-monitoring program to ensure that its priorities are directed toward reviewing overhead costs that have the greatest cost savings potential.

DOD agreed that operational audits had successfully identified ineffective or uneconomical contractor practices and had reduced costs for both contractors and DOD. However, DOD stated that it must devote its declining personnel resources to the areas of highest payback. Accordingly, DCAA intends to continue to allocate its resources on the basis of a formal planning system it uses to generate its work requirements. Within this system, operations audits are considered discretionary and are performed on the bases of perceived risk, available staff, and other factors.

We agree that DOD should devote its resources to the areas of highest payback. Nevertheless, we continue to believe that DCAA should increase the resources devoted to operations audits for several reasons. First, economy and efficiency audits, such as operations audits, frequently identify systemic problems that, if left uncorrected, continue to increase government costs on each new government contract. By identifying and correcting the underlying cause of the problem, DCAA will improve the internal controls and procedures used to develop and process such individual transactions as contract proposals and cost submissions. Thus, DCAA can, over time, devote fewer resources to auditing individual transactions. Improving internal controls and procedures is a fundamental objective underlying DOD's Contractor Risk Assessment Guide (CRAG). CRAG essentially establishes control objectives for five specific areas (indirect cost submissions, for example). If the contractor's internal controls and procedures meet the control objectives established for one or more of the areas, DOD can reduce the government oversite resources assigned to that area.

Second, while DCAA said it would continue to rely on its planning system, it did not conduct the operations audits identified by that system during the period of our review. Specifically, at the nine contractor sites we visited, DCAA performed about 30 percent (64 of 216) of the audits in its requirements plan and about half (64 of 128) of the audits in its annual program plan. The requirements plan identifies each local DCAA office's estimate of all necessary audits to be conducted during the next year, after considering the materiality of the area, the risk to the government, and the guidance and auditing standards established by DCAA and others. The program plan identifies the audits authorized by DCAA after adjusting the local requirements plan to account for staffing availability, agency priorities, and other factors.

Finally, we believe that the importance of operations audits has increased because of the current and planned decreases in defense procurement. As we discuss in this report, overhead rates have increased, and this trend will probably continue. In a declining business environment, rising overhead rates generally mean that a contractor's base for distributing overhead costs (generally direct labor hours or direct labor dollars) is decreasing faster than the contractor can shed overhead costs. To the extent that this trend continues, overhead costs will make up an increasing part of defense procurement costs. At the same time, decreasing business increases the potential for incurring unnecessary overhead costs. DCAA recognized this potential in its guidance to local activities for developing the fiscal year 1991 requirements plan. The guidance stated that, in addition to considering traditional risk assessment procedures, local activities should consider conducting operations audits that identify inefficiencies resulting from cutbacks in DOD procurement spending, such as the use of existing facilities.

DOD's comments on the draft of this report are included in their entirety as appendix VI.

Scope and Methodology

To determine the extent to which DOD used overhead should-cost reviews to help control contractor overhead costs, we analyzed the results of forward-pricing rate negotiations from 12 overhead should-cost reviews and 6 in-depth reviews. In addition, we analyzed the results of forward-pricing rate negotiations from the previous traditional reviews at each of these 18 contractors.

To conduct our analysis we asked DOD to identify all the reviews conducted from 1985 through 1989. We then contacted the appropriate administrative contracting offices to obtain the price negotiation memorandums, other documents that supported the negotiations that followed the review, and similar documents that supported one previous negotiation. Local contract administration officials divided the reviews into 29 overhead should-cost reviews and 19 in-depth reviews on the basis of the review scope and resources used. The information necessary to conduct our analysis was available for 18 of these reviews. We could not analyze the remaining reviews primarily because they did not result in a forward-pricing rate agreement.

To determine the extent to which DOD used operations audits and cost-monitoring reviews to help control contractor overhead costs, we selected a sample of nine contractors on the bases of the following criteria: each had annual sales to DOD of over $500 million in 1988, selected contractors were under the administrative responsibility of the each of the military services and DLA, and selected contractors had declining as well as increasing business sales.

At each of the nine contractors we obtained detailed information on the number and results of cost-monitoring reviews and operations audits completed by DOD. In addition, we met with contract administration officials to discuss their use of cost-monitoring reviews and operations audits.

To determine the trend in overhead rates, we obtained and analyzed overhead data for 1985 through 1989 at the two largest divisions of the 17 largest DOD contractors on the basis of fiscal year 1988 prime contract awards. Of the 17 contractors, one had only one division; thus, the total number of contractor organizations we obtained data on was 33.

In addition, we met with DLA and DCAA headquarters officials in Cameron Station, Virginia, to discuss the policies and procedures relating to conducting overhead should-cost reviews, cost-monitoring reviews, and operations audits.

We conducted our review from April 1990 through July 1991 in accordance with generally accepted government auditing standards.

As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report. A written statement must also be submitted to the House and

Senate Committees on Appropriations with an agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Directors of DLA and the DCAA. Copies will be made available to others upon request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix VII.

Sincerely yours,

Paul F. Math
Director, Research, Development, Acquisition,
and Procurement Issues

Results of Twelve Forward-Pricing Rate Agreement Negotiations in Which Overhead Should-Cost Reviews Were Used

Contractor	Amount of overhead (in millions)[a]			Percentage reduction[a]
	Proposed	Negotiated	Reduction	
A	$2,598	$2,232	$366	14.1
B	428	401	27	6.3
C	384	359	25	6.5
D	253	250	3	1.3
E	1,356	1,199	157	11.6
F	352	323	30	8.4
G	2,702	2,399	303	11.2
H	8,010	7,557	453	5.7
I	2,194	2,086	108	4.9
J	8,560	7,459	1,102	12.9
K	7,500	6,490	1,010	13.5
L	2,178	1,956	223	10.2
Total	**$36,516**	**$32,710**	**$3,807**	**10.4**

[a]Differences are due to rounding.

Results of Six Forward-Pricing Rate Agreement Negotiations in Which In-Depth Reviews Were Used

Contractor	Amount of overhead (in millions)[a]			Percentage reduction[a]
	Proposed	Negotiated	Reduction	
M	$396	$383	$12	3.2
N	322	290	32	9.9
O	518	492	26	5.0
P	82	79	3	3.2
Q	1,044	1,012	32	3.1
R	127	125	2	1.6
Total	**$2,488**	**$2,381**	**$107**	**4.3**

[a]Differences are due to rounding

Results of Eighteen Forward-Pricing Rate Agreement Negotiations in Which Traditional Reviews Were Used

Contractor	Amount of overhead (in millions)[a] Proposed	Negotiated	Reduction	Percentage reduction[a]
A	$435	$418	$17	3.9
B	244	231	13	5.1
C	385	384	1	.1
D	156	154	3	1.7
E	1,391	1,317	74	5.3
F	378	356	22	5.9
G	1,192	1,154	38	3.2
H	7,862	7,379	483	6.1
I	1,751	1,705	46	2.6
J	3,784	3,608	177	4.7
K	3,390	3,320	70	2.1
L	262	242	20	7.6
M	310	286	23	7.5
N	317	296	21	6.8
O	408	389	19	4.6
P	99	97	2	1.6
Q	933	928	5	.6
R	136	136	0	.3
Total	**$23,434**	**$22,400**	**$1,034**	**4.4**

[a]Differences are due to rounding.

Number of Cost-Monitoring Reviews of Overhead Costs at Nine Contractors' Locations (1987-90)

Contractor	1987	1988	1989	1990
Bell Helicopter	0	0	0	0
General Dynamics, Fort Worth	1	1	0	1
General Electric, Government Electronic Systems	3	2	1	1
General Electric, Lynn	8	5	5	3
Grumman, Aircraft Systems	5	3	0	0
Hughes, Radar Systems	0	0	0	0
Rockwell, North American Aircraft	2	1	0	0
Textron, Lycoming	0	1	3	4
Unisys, Great Neck	0	0	0	0
Total	**19**	**13**	**9**	**9**

Number of Operations Audits of Overhead Costs at Nine Contractors' Locations (1985-90)

Contractor	DCAA management year 1985	1986	1987	1988	1989	1990
Bell Helicopter	0	0	0	0	1	1
General Dynamics, Fort Worth	[a]	1	1	1	0	0
General Electric, Government Electronic Systems	3	1	1	0	1	1
General Electric, Lynn	1	1	1	0	3	1
Grumman, Aircraft Systems	3	4	0	4	1	1
Hughes, Radar Systems	1	2	0	3	0	2
Rockwell, North American Aircraft	2	0	2	0	1	1
Textron, Lycoming	3	1	1	2	1	4
Unisys, Great Neck	6	8	2	7	1	1
Total	**19**	**18**	**8**	**17**	**9**	**12**

[a]DCAA did not have records of the number of operations audits conducted at General Dynamics in 1985.

Comments From the Department of Defense

Note. GAO comments supplementing those in the report text appear at the end of this appendix.

OFFICE OF THE UNDER SECRETARY OF DEFENSE
WASHINGTON, DC 20301-3000

ACQUISITION
DP/CPF

OCT 10 1991

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "CONTRACT PRICING: Economy and Efficiency Audits Can Help Reduce Overhead Costs," dated August 23, 1991 (GAO Codes 396663 and 396667), OSD Case 8690-A. The Department concurs with Findings A-D, F-G, and Recommendation 1, and partially concurs with Finding E and Recommendation 2.

The GAO recommends that the Secretary of Defense direct the Directors of the Defense Logistics Agency and the Defense Contract Audit Agency to increase the priority of significant cost reduction measures, such as overhead should-cost reviews, cost-monitoring reviews, and operations audits (Recommendation 2). As stated in the DoD enclosure, the Defense Contract Management Command currently is evaluating its cost monitoring program to assure that priorities are directed to reviews that have the potential of yielding the greatest cost savings/cost avoidances in the overhead cost area. The Defense Contract Audit Agency already gives top priority to performing should-cost reviews. Operations audits are considered discretionary work by the Defense Contract Audit Agency and are performed based upon various factors, including perceived risk to the Government and resource constraints. The Department must devote its diminishing personnel resources to the areas of highest payback so it is not always possible to perform all the audits, should-costs, and reviews the GAO would wish us to do.

The detailed DoD comments are provided in the enclosure. The Department appreciates the opportunity to comment on the draft report.

Sincerely,

Eleanor Spector

Eleanor R. Spector
Director, Defense Procurement

Enclosure

GAO DRAFT REPORT - DATED AUGUST 23, 1991
(GAO CODES 396663 AND 396667) OSD CASE 8690-A

"CONTRACT PRICING: ECONOMY AND EFFICIENCY AUDITS
CAN HELP REDUCE OVERHEAD COSTS"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

o FINDING A: Overhead Costs. The GAO explained that overhead costs, also called indirect costs, benefit more than one contract and must be allocated to contracts on some reasonable basis. The GAO pointed out that the costs of facilities and equipment, general office support, computer operations, supervisor salaries, and security typically are classified as overhead because they are not directly assignable to a specific contract.

The GAO observed that, in December 1984, the Deputy Secretary of Defense announced a program to improve the DoD oversight of contractor overhead, which ultimately led to reductions in overhead costs. The GAO found that the program responded to the DoD concern that inadequate management attention and surveillance of contractor overhead costs may have allowed defense contractors to charge improper or excessive overhead costs to DoD contracts.

The GAO reported the Deputy Secretary emphasized the importance of avoiding pricing methods that place undue emphasis on historical costs. The GAO noted that, instead, the Deputy Secretary stated that DoD must use available evaluation tools--such as should-cost reviews, cost monitoring reviews, and operations audits to their fullest extent. (pp. 2-3/GAO Draft Report)

Now on p. 2.

DOD RESPONSE: Concur. The Department of Defense continues to be fully committed to controlling and reducing contractor indirect costs. For example, a comprehensive and formal contractor Cost Monitoring Program (which monitors contractor management and control of direct and indirect costs related to Government contracts) is in place at all major contractor locations in accordance with DoD Federal Acquisition Regulation Supplement 242.70.

Enclosure

The Defense Contract Management Command (DCMC) will continue to use cost monitoring program functional reviews, in-depth and overhead should-cost reviews, and forward pricing rate proposal reviews as evaluation tools for performing oversight of contractor overhead costs. In addition, DCMC contract administration offices will participate in program should-cost reviews when requested by the buying commands.

o FINDING B: Decrease in the Use of Overhead Should-Cost Reviews. The GAO observed that overhead should-cost reviews are a specialized form of cost analysis that differs from traditional DoD evaluation methods. The GAO explained that during traditional reviews, local contract audit and contract administration personnel primarily base their evaluation of forecasted expenses on an evaluation of historical costs and trends. The GAO pointed out that in contrast, overhead should-cost reviews do not assume that the historical costs of a contractor reflect efficient and economical operations. The GAO found that the reviews evaluate the economy and efficiency of the existing work force of the contractor, methods, materials, facilities, operating systems, and management. The GAO reported that the reviews use an integrated team of DoD contracting, contract administration, pricing, audit, and engineering representatives to conduct a comprehensive evaluation of overhead costs to identify both short- and long-range improvements that need to be made to improve the economy and efficiency of a contractor operations.

The GAO found that, as one of the initial steps in the DoD program to reduce overhead costs, the Deputy Secretary directed the Army, the Navy, the Air Force, and the Defense Logistics Agency to each perform at least one overhead should-cost review during FY 1985, FY 1986, and FY 1987. The GAO reported, however, that absent additional DoD-level direction, the Military Services stopped conducting the reviews after FY 1988. The GAO also noted that, although the Defense Logistics Agency has continued to perform overhead should-cost reviews, the agency has relied increasingly on "in-depth reviews" to evaluate contractors proposed overhead costs.

The GAO observed that in-depth reviews, like overhead should-cost reviews, evaluate the economy and efficiency of a contractor operation. The GAO found, however, that in-depth reviews do not approach the depth of coverage or resources used in overhead should-cost reviews. The GAO indicated, for example, that overhead should-cost reviews employ integrated teams of Government contracting, contract administration, pricing, audit, and engineering representatives from local audit and contract administration offices, as well as personnel from DoD purchasing offices and regional or headquarters audit and contract administration offices. The GAO explained that in-depth teams, on the other hand, are normally limited to local Defense Contract Audit Agency and contract administration personnel. The GAO further noted that, moreover, overhead should-cost review teams average 36 staff--more than three times the average number on the in-depth review teams.

According to the GAO, DoD officials cited a variety of reasons for the decline in overhead should-cost reviews. The GAO noted, for example, that inadequate travel funds and nonavailability of personnel from DoD buying activities and regional or headquarters audit and contract administration offices were cited as key reasons for the decline. The GAO emphasized that the DoD officials, while citing the problems in conducting should-reviews, also acknowledged that overhead should-cost reviews resulted in significant savings to the Government. The GAO concluded that the potential benefits of conducting overhead should-cost reviews far exceed the additional costs involved in providing personnel and travel funds to conduct the reviews. (pp. 3-6/GAO Draft Report)

Now on pp. 2-4.

DOD RESPONSE: Concur. Although the Department has not directed the Services to continue to perform overhead should-cost reviews, the Services have the latitude to perform such reviews when deemed appropriate. However, the creation of the Defense Contract Management Command in February 1990 (which is responsible for contract administration services previously performed worldwide by both the Defense Logistics Agency and the Military Services) obviates the need for the Services to perform overhead should-cost reviews. The Defense Contract Management Command/Defense Logistics Agency did continue to perform overhead should-cost reviews.

The lack of adequate travel funds and resources continues to be a major obstacle to performing labor-intensive overhead should-cost reviews. The current and projected decline in the defense budget and resultant drawdown in Government personnel will exacerbate the situation.

The GAO observed that the average size of an overhead should-cost review team was 36 personnel, which is nearly three times larger than DLA in-depth review teams. That observation implies larger review teams will result in larger savings to the Government. The Department notes, however, that there is no valid correlation between the size of a review team and its reported savings. For example, a three-fold increase in the size of a review team will not necessarily result in a three-fold increase in savings. The Department asserts that the experience, knowledge, and dedication of the review team participants is more important than the number of personnel assigned to the team.

o **FINDING C**: Results Achieved During Forward Pricing Rate Agreemant Negotiations. The GAO contended that overhead should-cost reviews provide DoD contracting officers a basis for evaluating contractors proposed overhead costs and negotiating forward pricing rate agreements. The GAO explained that forward pricing rate agreements are written agreements between contractors and the DoD to use certain overhead rates in the negotiation of contracts or contract modifications over a specified period of time. According to the GAO, the agreements eliminate the need to negotiate separate overhead rates for each contract or contract modification.

The GAO reported that the Deputy Secretary of Defense, in establishing the DoD program to reduce contractor overhead costs in December 1984, acknowledged that the forward pricing rate agreement process afforded an excellent opportunity to control and influence contractor overhead. The GAO noted that approximately one year after being directed to perform overhead should-cost reviews, the Services and the Defense Logistics Agency were asked to brief the Deputy Secretary on the results of their reviews. According to the GAO, the briefings indicated that the overhead should-cost reviews were successful and resulted in significant cost savings for the DoD. For example, the GAO found that the five overhead should-cost reviews completed in FY 1985 yielded an estimated savings of $1.1 billion, as compared to Government and contractor costs of performing the reviews of only $2.4 million.

The GAO pointed out that the DoD acknowledges overhead should-cost reviews have resulted in significant savings. In addition, the GAO pointed out its analysis supports the conclusion that the potential for such savings continues to exist. The GAO found that, when should-cost reviews were conducted, contracting officers reduced contractor-proposed overhead costs by over 10 percent. (pp. 6-8/GAO Draft Report)

Now on pp. 4-5.

DOD RESPONSE: Concur. With limited resources available and the significant amount of effort and cost associated with performing an overhead should-cost review, savings must be considered in light of other activities those same people are neglecting.

o **FINDING D: DoD Regulations Do Not Provide For Guidance For Conducting Overhead Should-Cost Reviews.** The GAO reported that, in directing the Services and the Defense Logistics Agency to perform overhead should-cost reviews, the Deputy Secretary stated that, if the approach subsequently proves to be viable, then changes would be made to the DoD regulations. The GAO pointed out that, although the DoD initial assessments indicated that the overhead should-cost reviews were viable and produced significant savings, the DoD still has not revised its regulations to ensure that the reviews are performed. The GAO also noted that the Services stopped conducting should-cost reviews in 1988—and the Defense Logistics Agency has turned increasingly to in-depth reviews.

The GAO referenced a September 1985 report issued by the Office of the Inspector General, DoD, which identified a number of inadequacies in the DoD should-cost policy that resulted in under-utilizing the should-cost concept to evaluate individual contract proposals. Among other things, the GAO pointed out that the Inspector General report concluded that the Services were given too much latitude in determining when to do should-cost reviews and there was no DoD-level oversight to ensure that the DoD should-cost policy was implemented effectively. The GAO reported the Inspector General recommended that a DoD should-cost policy be incorporated into the Defense Federal Acquisition Regulation Supplement. The GAO concluded, however, that the Department has not established any policy for conducting overhead should-cost reviews. (pp. 8-9/GAO Draft Report)

Now on pp. 5-6.

DOD RESPONSE: Concur. The DoD regulations currently do not provide explicit policy and guidance for performing overhead should-cost reviews. However, DoD procurement regulations currently provide policy and guidance for performing should-cost reviews for production programs. Overhead should-cost reviews are implicitly addressed in the existing Federal Acquisition Regulation coverage, which states "...the scope of a should-cost analysis can range from a large-scale review examining the contractor's entire operation (including plant-wide overhead...)" [emphasis added].

o **FINDING E: Cost-Monitoring Reviews Declining.** The GAO observed that cost-monitoring reviews, like overhead should-cost reviews, evaluate the economy and efficiency of the operations of a contractor. The GAO explained that unlike overhead should-cost reviews, which use a large, multi-organizational staff to review all proposed overhead costs, cost-monitoring reviews are conducted primarily by the Defense Logistics Agency to evaluate a specific contractor function. The GAO cited an example where the scope of a cost-monitoring review could be limited to evaluating a specific aspect of indirect labor utilization, facilities management, space utilization, equipment disposition, or material receiving and storage. The GAO noted that the Defense Logistics Agency has identified more than 50 such evaluation areas.

The GAO found that the total number of cost-monitoring reviews involving overhead costs performed at nine selected contractors had diminished since 1987. The GAO pointed out that DoD regulations state that each significant contract operation should be reviewed over a 2 to 3-year period. The GAO indicated that, during the three year period ending December 31, 1990, however, no overhead cost-monitoring reviews were conducted at three of the nine contractors it reviewed--and four or fewer reviews were conducted at seven of the nine contractors.

According to the GAO, local contract administration officials said that they did not have the resources to perform additional cost-monitoring reviews. The GAO reported those same officials also said that such reviews had a lower priority than such tasks as (1) reviewing forward-pricing rate proposals and (2) overhead rate tracking, which are directed at the prices of contracts currently being negotiated.

The GAO acknowledged that reviewing forward-pricing rate proposals and overhead rate tracking are important activities. The GAO emphasized, however, that exclusive of the occasional use of an overhead should-cost review to evaluate a forward-pricing rate proposal, those activities are primarily directed toward using historical costs as a basis for evaluating forecasted expenses. The GAO asserted, however, that they do not serve as a substitute for cost-monitoring reviews--which determine whether a contractor is managing or using its resources economically and efficiently.

The GAO concluded that cost-monitoring reviews successfully have identified and eliminated ineffective or uneconomical contractor practices. The GAO cited a DoD Inspector General Report (Audit Report No. 87-184, July 1987), in which the Office of the Inspector General found that cost-monitoring reviews completed at six contractors during 1984 identified $134 million in avoidable costs. The GAO pointed out that, at the time of the Inspector General Report, contractors had agreed to corrective actions relating to about $75 million. The GAO pointed out that more recent cost-monitoring reviews completed at the contractors

Now on p.1, pp. 6-8.

reviewed by the GAO had also identified unnecessary costs. (pp. 1-2, pp. 9-12/GAO Draft Report)

DOD RESPONSE: Partially Concur. The GAO should clarify that the three locations that were not performing overhead cost monitoring reviews were not under the Defense Contract Management Command cognizance for most of the three year period reviewed. (The Defense Contract Management Command did not have full cognizance of the Service Defense Plant Representative Offices until late in calendar year 1990.) The Defense Contract Management Command has continued to emphasize the importance of functional reviews. The Defense Contract Management Command reviews represent nearly three-fourths of the total reviews performed from 1987 to 1990.

- FINDING F: Reduction in Use of Operations Audits. The GAO found that operations audits, which are conducted by the Defense Contract Audit Agency, are essentially the same as cost-monitoring reviews conducted by the Defense Logistics Agency. The GAO explained that an operations audit evaluates the economy and efficiency of a specific contractor function or operation. The GAO indicated that the reviews result in recommendations to eliminate unnecessary costs or waste. The GAO explained that recommendations can range from implementing new, emerging technologies--to changing existing contractor functions, policies, procedures, or practices.

  The GAO found that the Defense Contract Audit Agency had reduced its use of operations audits as a tool to identify unnecessary contractor costs. The GAO determined that the number of staff days the Defense Contract Audit Agency spent on operations audits of costs decreased from 18,411 in FY 1985 to 9,300 in FY 1990--a decrease of almost 50 percent. The GAO calculated that the decrease in operations audits represented a decline from more than 3 percent of Defense Contract Audit Agency direct audit time to less than 1 percent.

  The GAO noted that the decrease in staff days devoted to operations audits was reflected in the number of audits of overhead costs performed at the nine contractors the GAO reviewed. The GAO pointed out that the number of operations audits of overhead costs conducted by Defense Contract Audit Agency decreased from 19 in 1985 to 12 in 1990--a decrease of 37 percent.

  The GAO reported that, according to Defense Contract Audit Agency officials, the decrease in the frequency of operations audits was due to a shift in audit emphasis away from operations audits to other types of reviews--such as post-award reviews and incurred cost audits. The GAO pointed out, however, that Defense Contract Audit Agency field offices have recognized the need for more operations audits. The GAO noted that Defense Contract Audit Agency annual requirements plans for 1985 through 1990 for the nine contractors it [the GAO] reviewed identified a need for 218 operations audits of overhead costs. The GAO found that only 66 (about 30 percent) were conducted in the year planned. The GAO reported that several local Defense Contract Audit Agency officials confirmed that fewer operations audits were conducted because of the low priority given to such audits.

The GAO asserted that operations audits successfully have identified ineffective or uneconomical contractor practices. The GAO cited a DoD Inspector General review that reported the Defense Contract Audit Agency issued 348 operation audit reports that identified avoidable costs of $244.8 million during the 12-month period ending March 30, 1984 (Audit Policy and Oversight Report No. 85-077). (pp. 1-2, pp. 12-15/GAO Draft Report)

Now on p.1, pp. 8-11.

DOD RESPONSE: Concur. It should be noted, however, the 37 percent reduction in the number of operations audits of overhead costs that the GAO cites for nine contractors is heavily skewed because of the inclusion of Unisys Corporation, where the Defense Contract Audit Agency performed nearly one-third of all of the audits for the nine contractors in the first year of the study, and where the percentage declined by 83 percent. If Unisys is eliminated, the percentage decrease for the remaining eight contractors would be only 15 percent. In addition, resources were shifted to incurred cost audits (because of the very significant backlog) and to defective pricing reviews.

o FINDING G: **Overhead Rates Increased as Defense Contract Awards Declined**. The GAO found that, since 1987, overhead rates at many major DoD contractors have increased, as the value of contracts awarded by the DoD declined. The GAO pointed out that prime contract awards decreased from $150.7 billion in 1985 to $129 billion in 1989. The GAO observed that the decrease in business at many large contractors contributed to the increasing overhead rates, because the remaining DoD contracts were forced to absorb additional overhead costs. The GAO reviewed three major overhead rates at 33 contractors and found that 80 percent of the overhead rates increased between 1987 and 1989, regardless of percentage changes in sales. The GAO further found that they increased much faster as sales declined.

The GAO pointed out that higher overhead rates increase contract costs. The GAO reported that, during the period 1985 to 1989, when sales to the DoD declined after the completion of a major program, the overhead rates at one contractor increased by 47 percent for engineering, 83 percent for manufacturing, and 114 percent for general and administrative expenses. According to the GAO, those higher overhead rates will be used as the basis for estimating the cost of future contracts and the final cost of existing cost-type and flexibly-priced contracts. (pp. 1-2, pp. 15-17/GAO Draft Report)

Now on p. 1, pp. 11-12.

DOD RESPONSE: Concur. The following points are also relevant:

(1) GAO states that "The higher overhead rates will be used as the basis for estimating the cost of future contracts...." The statement implies that rates for future contracts will be high solely because recent historical rates have been high. However, the process by which future overhead rates are projected is based in large measure on the best predictions that can be made of costs and business volume. If trends in those factors show signs of change, particularly the business base, projected rates may differ dramatically from historical rates.

(2) Increases in overhead rates occur not only because allocation bases decline, but also because overhead pools increase. One recent factor influencing the increase in overhead rates is the substitution of capital (machines) for direct labor in manufacturing. That simultaneously increases the overhead pool (by adding depreciation costs), and usually decreases the allocation base (which is often direct labor). With that in mind, it is interesting to note some operations audits, by recommending the acquisition of advanced machinery, actually contribute to the increase in overhead rates, even as they reduce overall costs. In response to the reduction in the usefulness of direct labor as a suitable allocation base, many contractors are implementing advanced cost management systems, which may use bases such as machine hours or cycles for the allocation of indirect costs.

The Defense Contract Management Command will continue to review overhead costs for reasonableness, allocability, and allowability in accordance with Federal Acquisition Regulation Part 31, Contract Cost Principles and Procedures. Additionally, contractor costs will continue to be reviewed based on risk assessments, as required by Defense Federal Acquisition Regulation Supplement 42.70, Monitoring Contractor Costs.

o **FINDING H: Planned Resource Reductions May Further Reduce the DoD Use of Economy and Efficiency Audits**. The GAO observed that the FY 1991 National Defense Authorization Act requires the DoD to cut the acquisition work force by 4 percent each year for the next 5 years. The GAO estimated that mandated 20-percent reduction could reduce the acquisition work force by about as many as 107,000 over the 5-year period. The GAO further observed that the Act mandated a similar reduction in DoD management headquarter activities and DoD headquarter support activities. The GAO pointed out that the cited reduction exemplifies the overall downsizing of DoD operations.

The GAO indicated that the Defense Logistics Agency and the Defense Contract Audit Agency staffing levels are being reduced, although the extent of the reductions and their effect on the ability of the Defense Logistics Agency and the Defense Contract Audit Agency to conduct economy and efficiency reviews is unclear. The GAO reported that, according to the Defense Contract Management Command of the Defense Logistics Agency, the authorized year-end staff level will be reduced by 1,900 (or about 9 percent) during the two-year period ending September 30, 1993. The GAO further reported that, according to the Defense Contract Audit Agency, its authorized year-end staff will be reduced by over 1,100 (or about 15 percent) in FY 1991. The GAO emphasized that both organizations may be required to absorb additional staff reductions in the future. (pp. 1-2, pp. 17-18/GAO Draft Report)

Now on p. 1, p. 13.

DOD RESPONSE: Concur. As indicated, the effect of the impending resource reductions on the ability of the Defense Contract Management Command and the Defense Contract Audit Agency to conduct economy and efficiency reviews is unclear. As explained in the DoD Response to Recommendation 2, the Defense Contract Audit Agency effort in the area of operations audits is driven by many factors, of which staff levels is only one. For example, the GAO notes that from 1985 to 1990, the Defense Contract Audit Agency effort on operations audits decreased about 50 percent (pp. 12/GAO Draft Report). During that same period, however, the Defense Contract Audit Agency actual year end audit staffing increased by 45 percent. The DoD Response to Recommendation 2 notes that the Defense Contract Audit Agency allocation of resources to its many areas of audit responsibility is based upon the level of services demanded by audit customers, risk and vulnerability assessment, areas of perceived special interest, as well as overall staffing.

Now on p. 9.

In a period of declining Defense budgets, the Defense Contract Management Command will have to decrease its resources in line with a declining workload. The Defense Contract Management Command concept of Performance Based Management is designed to concentrate on areas of higher relative risk.

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RECOMMENDATIONS

o <u>RECOMMENDATION 1</u>: The GAO recommended that the Secretary of Defense revise the DoD procurement regulations to provide guidance for the use of overhead should-cost reviews. According to the GAO, the regulations should include guidance similar to that currently provided for contract should-cost reviews, including criteria to select review sites. (p. 12/GAO Draft Report)

Now on p. 13.

<u>DOD RESPONSE</u>: Concur. The Department will revise the procurement regulations, as recommended, including providing criteria to select review sites and participation of the Services and others. Action to initiate the regulatory revision will be initiated during the first quarter of FY 1992, with implementation expected later in the fiscal year. The regulatory guidance and results of overhead should-cost reviews will be reviewed (after the amended regulation has been in place for at least a year) to determine whether the overhead should-cost reviews are cost effective and whether additional regulatory revision is warranted.

The Department agrees that overhead should-cost reviews have a potential for savings, but it also must be recognized that such reviews are labor intensive and require participation by the buying activities, contract administration, and contract audit elements—all of which currently are experiencing significant resource reductions. The extent of availability of Service resources to support the Defense Logistics Agency-led teams will be a determining factor in whether a review is conducted. Within the next 90 days, the Office of the Director, Defense Procurement, will issue memorandum guidance encouraging the conduct of overhead should-cost reviews when there are indications that the normal evaluation and negotiation process would not be sufficient.

o <u>RECOMMENDATION 2</u>: The GAO recommended that the Secretary of Defense direct the Directors of the Defense Logistics Agency and the Defense Contract Audit Agency to increase the priority of significant cost reduction measures, such as overhead should-cost reviews, cost-monitoring reviews, and operations audits. (p. 18/GAO Draft Report)

Now on p. 13.

DOD RESPONSE: Partially concur. The Defense Contract Management Command is currently evaluating its cost monitoring program to assure that priorities are directed to reviews having the potential of yielding the greatest cost savings/cost avoidances in the overhead cost area.

Contracting officers determine when a should-cost review is to be performed and what elements of the contractor operation should be reviewed (see Federal Acquisition Regulation 15.810 and Defense Federal Acquisition Regulation Supplement 215.810). Participation by Defense Contract Audit Agency auditors on should-cost reviews is considered a demand assignment by the Defense Contract Audit Agency. Demand assignments are given top priority and are accomplished before discretionary assignments, such as operations audits and incurred cost audits.

Demand assignments are those audits performed as a result of an audit request from a source outside of the field audit office performing the audit. Discretionary assignments are self-initiated by the Defense Contract Audit Agency. Following is a listing of the major types of audits performed by the Defense Contract Audit Agency, classified as to whether they are primarily demand or discretionary.

Primarily Demand Audits

1. Proposals
2. Forward pricing rate agreements
3. Should-cost reviews
4. Special audits (terminations, claims, progress payments)
5. Negotiation attendance

Primarily Discretionary Audits

1. Estimating system surveys
2. Defective pricing reviews
3. Material management and accounting systems
4. Cost accounting standards
5. Operations audits
6. Incurred cost audits

On an annual basis, the Defense Contract Audit Agency Headquarters reviews the field audit office anticipated requirements for performing both demand and discretionary audits. After audit resources are provided for the performance of demand audits, a program is established for the performance of as much discretionary work as possible, given the remaining resources. Allocation of resources to the various types of discretionary audits is primarily based upon perceived risk to the Government, which considers such factors as the likelihood of unallowable costs, the potential for fraud, and the possible cost savings which may result from the performance of an audit.

In addition to the general risk assessment criteria discussed above, the resources devoted to each type of discretionary audit are affected by certain unique factors. For example, recent changes to the Federal Acquisition Regulation in the areas of estimating system surveys and material management and accounting systems has increased the emphasis of these types of reviews. The reestablishment of the Cost Accounting Standards Board has placed increased emphasis on CAS reviews. The Defense Contract Audit Agency must also maintain a program of reviewing contracts for defective pricing in order to monitor contractor compliance with the Truth In Negotiation Act.

The same FY 1991 National Defense Authorization Act which requires DoD to cut its acquisition work force during the next five years also includes language that eliminates the "M" account (obligated but unexpended) funds over the next two years, beginning with funds authorized in FY 1983 and prior. Once those funds are eliminated, any costs to be paid relating to the concerned contracts must be paid out of current fiscal year appropriations. Decreasing the audit resources allocated to incurred cost audits in order to increase resources for operations audits could result in the loss of "M" account funds through lack of audit completion. Currently, there is a backlog of over 12,000 contractor fiscal years to be audited by the Defense Contract Audit Agency. Almost 4,500 of the backlogged audits are for FY 1988 and prior.

The Department agrees that operations audits successfully have identified ineffective or uneconomical contractor practices and have resulted in the implementation of more efficient procedures and operations and reduced costs for both contractors and DoD. Nevertheless, the Defense Contract Audit Agency has considerable responsibilities for performing many other types of reviews and audits, all of which are designed to support the acquisition community in its procurement efforts, reduce the risks faced by the Government on its contracts, or prevent the payment of inappropriate costs. Accordingly, the Defense Contract Audit Agency will continue to allocate its resources based upon current procedures. The Department agrees that the current procedures are appropriate and should not be changed.

The following is GAO's comments on DOD's letter dated October 10, 1991.

GAO Comment

1. We have modified the report where appropriate to incorporate the clarifications and comments provided by DOD.

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