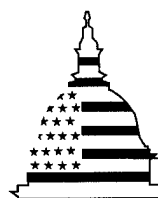


October 1999

CONTRACT
MANAGEMENT

DOD Begins New
Effort to Improve
Reporting of Contract
Service Costs



G A O

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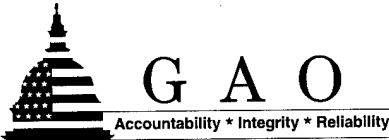
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Abbreviations

DOD Department of Defense



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

National Security and
International Affairs Division

B-282596

October 13, 1999

Congressional Committees

Although the Department of Defense (DOD) is increasing its reliance on contractor support, long-standing concerns exist regarding the accuracy and reliability of its accounting for the costs of contract services, particularly advisory and assistance services.¹ Congress has expressed its concern that without accurate and reliable data in this area, appropriate oversight may be hampered. In May 1998, we reported that the Army had erroneously included costs for some advisory and assistance services in the miscellaneous service budget category and that the miscellaneous category comprised a large portion of total contract services—\$47 billion out of \$96 billion in fiscal year 1996.² In fiscal year 1998, reported contract service costs totaled about \$90 billion. In 1998, Congress imposed a statutory limit on the percentage of total contract service costs that may be reported in the miscellaneous category.³ This limit was set at 30 percent of total contract service costs in fiscal year 2000 and at 15 percent in 2001 and thereafter. Additionally, Congress required (1) DOD to review and report annually on its proposed budget submission to ensure that contract services meeting the definition of advisory and assistance services are properly classified and (2) that we review DOD's report. Our objective for this report was to determine the actions taken by DOD to improve the accuracy of its reporting of costs for contract services.

Results in Brief

DOD has taken a number of steps intended to improve the accuracy of costs reported for contract services but recognizes more needs to be done.

¹Contract services are services, for example, provided by contractors to assist program offices in a variety of ways and to maintain equipment and facilities. There are eight categories of contract services, including (1) advisory and assistance services, which include services to support policy development, decision-making, or program management; (2) research and development services; and (3) miscellaneous services—a broad category of services that do not fit within one of the other categories. See appendix I for definitions of all eight categories.

²*DOD Consulting Services: Erroneous Accounting and Reporting of Costs* (GAO/NSIAD-98-136, May 18, 1998).

³Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, section 911.

In an effort to achieve greater accuracy and consistency in reporting costs Department-wide, in November 1998 it provided guidance to the military services and Defense agencies on identifying and reporting contract service costs. This guidance included specific examples of the types of services that DOD had determined were being erroneously included in the miscellaneous service category, along with direction on the correct category in which to report those services. For example, it stated that environmental restoration and pollution prevention costs were not to be reported in the miscellaneous category but rather in the land and structure category. Following this guidance, DOD reported that the military services and Defense agencies realigned about \$30 billion of the fiscal year 1998 costs that had been incorrectly reported in the miscellaneous service category to other categories they determined were more appropriate.

Despite these efforts, DOD officials stated that they could not ensure the accuracy of the classification of contract service costs reported for advisory and assistance services because of inconsistencies in reporting by the military services. In its 1999 report to Congress, the Department also expressed concern about the difficulty in distinguishing between advisory and assistance services and other contract service costs and recommended revising the way contract service costs are reported. DOD recommended that they identify what the contract service supports rather than identifying the type of service provided such as advisory and assistance services. DOD's recommendation, as presented in its report, would represent a major change in how contract service costs are reported. The change may not provide the visibility Congress desires over contract services, if all contract service costs are classified according to what they support rather than the type of service provided. DOD, however, has not provided specific details regarding this recommendation, and according to officials in the Office of the Secretary of Defense, the Department does not expect to provide such details until the spring or summer of 2000.

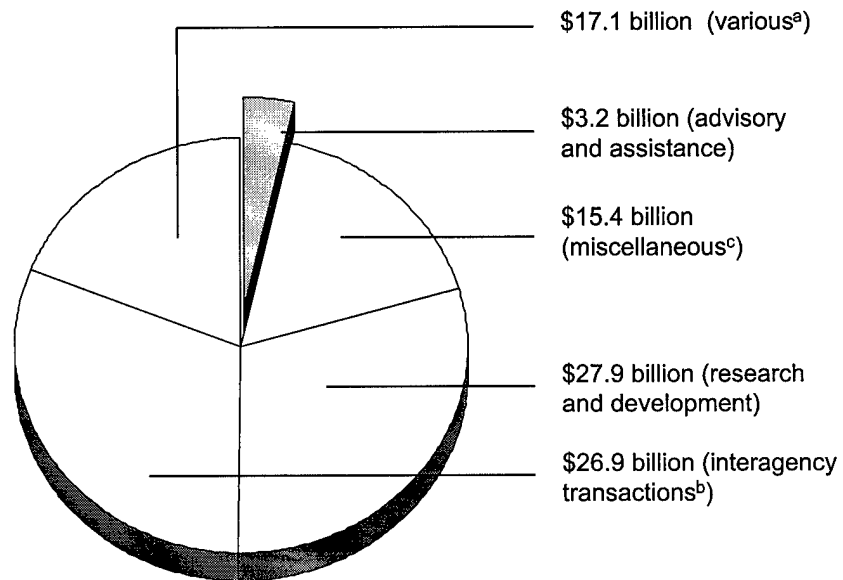
Background

DOD reports actual and estimated future costs⁴ for contract services using the object class structure provided in Office of Management and Budget Circular A-11. This structure identifies costs for each government account

⁴The Office of Management and Budget's Circular A-11 refers to "obligations", both planned and actual obligations, which are the amounts of orders placed, contracts awarded, services received, and similar actions requiring payments. For simplicity, we have used the term "costs" throughout the remainder of this report.

according to the nature of the goods or services purchased. Contract services are reported in the object class 25 series—other contractual services—under one of several categories. Figure 1 shows DOD's reported costs for contract services, which totaled \$90.5 billion in fiscal year 1998. See appendix I for a description of the categories for contract services.

Figure 1: DOD's Reported Contract Services in Fiscal Year 1998



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

^b Purchases from other government agencies.

^c This covers miscellaneous services (also called other services), which include services that do not fit within one of the other remaining contract service categories.

Source: Federal budget, fiscal year 2000/2001 and DOD's June 1999 report to Congress.

There are three categories of advisory and assistance services: (1) management and professional support services; (2) studies, analyses, and evaluations; and (3) engineering and technical services. In addition to requiring DOD to report on the accuracy of advisory and assistance service costs and limiting the amounts reported under miscellaneous services, the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 provided specific definitions for these three categories. The act also provided a list of services that are exempt from classification as advisory

and assistance services such as certain systems engineering and technical services. The exemptions are summarized in appendix II.

Steps Taken to Improve Accounting for Contract Services; but Further Efforts Needed

DOD has taken steps to improve reporting of contract service costs but has also acknowledged that further efforts are required. In its June 1999 report, *Report to Congress on Improved Accounting for Defense Contract Services*, DOD stated that it had reviewed the costs reported for miscellaneous services to determine whether they had been properly classified. Specifically, DOD and service officials stated that they had reviewed miscellaneous service costs for fiscal year 1998 and found that costs for certain types of services such as environmental restoration had been reported inconsistently or had been erroneously included in the miscellaneous services category. To correct reporting errors and provide greater consistency throughout the Department in reporting contract service costs, the DOD Comptroller issued guidance in November 1998 that provided specific directions as to the proper category in which these services should be reported. The guidance required the military services to realign certain costs from the miscellaneous service category to other categories.

Officials from the DOD Comptroller's office stated that they provided the guidance on realigning the miscellaneous category to DOD and military service components and relied on the components to make the necessary adjustments. The Comptroller's office did not attempt to verify the adjustments. DOD and service officials responsible for providing the data told us that the realignment of the miscellaneous costs was made under tight time constraints, sometimes with limited data. In some instances, the realignment was based on telephone calls to program offices and on quick analyses, while in others cases, budget officials and analysts were left to estimate, without program office input, which costs should go in other categories. Officials in the military services acknowledged that their methodology was not the best but added that it was the best they could do under the time constraints stipulated for the review. We did not independently assess the accuracy of the adjustments. However, some DOD and service officials told us that they could not ensure the accuracy of the revised accounting for contract services.

After this effort, DOD reported that it had reduced the costs included in the miscellaneous service category, which in prior years accounted for about 50 percent of total contract services. Specifically, in fiscal year 1998, it reported that miscellaneous services, as realigned, were about 17 percent

of total reported costs for contract services. DOD anticipates costs in the miscellaneous service category will comprise about 15 and 14 percent of total reported costs for contract services in 1999 and 2000, respectively. The 14-percent amount is below the 30-percent limit Congress stipulated for fiscal year 2000.

DOD further reported that amounts for the miscellaneous service category in the fiscal year 2000/2001 budget decreased significantly below the amount in the miscellaneous service category in the fiscal year 1999 President's budget. As shown in table 1, DOD reported a decrease in the miscellaneous service category of about \$30 billion for fiscal year 1998 and about \$33 billion for fiscal year 1999. It stated that this decrease was offset by increases in other object classes it deemed more appropriately describe the costs involved. Most of the adjustments were made within the contract service object class; however, some costs were realigned to other object classes.

Table 1: DOD's Realignment of Costs From the Miscellaneous Services Category

Dollars in millions		
Categories	Fiscal year 1998	Fiscal year 1999
Miscellaneous services (total decrease)	-30,075	-33,456
Increase in contract services object class		
Advisory and assistance services	+ 1,141	+ 1,009
Purchases from government accounts	+3,903	+3,276
Operations and maintenance of facilities	+4,383	+3,799
Research and development contracts	+10,565	+9,702
Medical care	+1,553	+2,573
Operations and maintenance of equipment	+4,972	+5,927
Subsistence/support of persons	+150	+151
Increase in object classes outside contract services	+3,409	+7,017
Total increase in other contract services categories and other object classes	+30,076	+33,454^a

^a Amounts do not total due to rounding.

Source: DOD's June 1999 report to Congress.

Despite these efforts, DOD and military service officials recognize that the Department's reporting will continue to contain some errors and

inconsistencies. DOD acknowledged this in its June 1999 report to Congress, stating that its review “demonstrated that the current system for reporting these costs had been and will probably continue to be unsuccessful—due to difficulty in identifying and valuing the service provided by contractors.” DOD officials stated that they could not ensure the accuracy of the accounting for contract service costs, particularly advisory and assistance service costs, because of inconsistencies in reporting by the military services. For example, some service officials used the exemptions for advisory and assistance service categories stipulated in the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, while others did not. We were told that although the statutory changes to the definition of advisory and assistance services and the exemptions were passed in September 1998, many budget numbers had already been submitted using the existing Office of Management and Budget definitions and exemptions. While many of the statutory exemptions are also contained in the Office of Management and Budget’s Circular, there are some differences that could lead to changes in the way certain types of contract services (such as automated data processing) will be reported in the future. DOD officials stated that they were working to provide consistent guidance in this area. Regarding the accuracy of reported advisory and assistance service costs, DOD Comptroller officials stated that time did not allow for a complete budgetary analysis or review of contract service costs to ensure reliability.⁵

Our work identified instances in which some contract service costs were not properly reported in the June 1999 report to Congress. For example, the Defense Logistics Agency reported \$18.6 million in advisory and assistance services under miscellaneous services for fiscal year 1998 because its guidance erroneously stated that these costs should be reported under the miscellaneous category. In another instance, an official from the Defense Threat Reduction Agency told us that the agency had not reported some contract service costs in fiscal year 1998 due to a misinterpretation of the guidance. We were told that these errors would be corrected in the future.

⁵ In addition, in our most recent audit of the federal government’s 1998 consolidated financial statements, we reported that DOD’s financial management systems do not capture the full cost of its activities and programs. Specifically, we reported that DOD is unable to provide actual data on the costs associated with functions. *Department of Defense: Status of Financial Management Weaknesses and Actions Needed to Correct Continuing Challenges* (GAO/T-AIMD/NSIAD-99-171, May 4, 1999).

DOD Recommends Change to Improve Reporting of Contract Service Costs

DOD has recommended changing the reporting structure for contract services by revising the object class categories found in Office of Management and Budget Circular A-11. In its June 1999 report to Congress, DOD recommended that the object class structure be revised to identify what a specific contract service supports (for example, weapon systems) rather than identifying what the service is (such as advisory and assistance services' analyses or evaluations). DOD's report stated that this type of information would provide more accurate and useful data. According to DOD and service officials, this information could provide greater visibility on what the contract service was for and where the impact of a funding cut would occur.

While we agree that it would be beneficial to know how much the government spends to support specific programs and functions, DOD's recommendation, as presented in its report, would represent a major change in how contract service costs are reported. The change may not provide the visibility Congress desires over contract services if all contract service costs are classified according to what they support rather than by the type of service provided. DOD has offered to work with the various interested congressional committees and the Office of Management and Budget on this effort with the objective of improving the relevance of the data for both Congress and the executive branch. DOD, however, has not provided specifics regarding its recommendation and, according to officials from the Office of the Secretary of Defense, is not expected to do so until the spring or summer of 2000.

Agency Comments

We provided a draft of this report to DOD for formal review and comment. In its oral reply, DOD said that it had no substantive comments. It, however, provided one technical comment about how we characterized costs reported by the Defense Threat Reduction Agency. We have incorporated DOD's suggestion in this report.

Scope and Methodology

We performed our work at the Office of the Secretary of Defense Comptroller's office and at the offices of DOD and service components that use advisory and assistance services and miscellaneous services. These include the Air Force's Air Force Material Command and Aeronautical Systems Center; the Navy's Naval Sea Systems Command, Naval Air Systems Command, Space and Naval Warfare Systems Command, Office of Naval Research, and U.S. Pacific and Atlantic Fleets; the Army's Office of

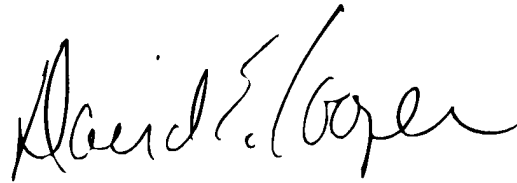
the Assistant Secretary of the Army for Acquisition, Logistics, and Technology, and Communications and Electronics Command; and the Defense Information Systems Agency, the National Imagery and Mapping Agency, the Defense Logistics Agency, the Joint Staff, and the Defense Threat Reduction Agency.

To identify actions taken to improve reporting for contract service costs, we interviewed officials from the above activities responsible for managing and reporting on contract services. Among other things, we obtained information regarding the methodology used to develop the June 1999 report, titled *Report to Congress on Improved Accounting for Defense Contract Services*, including DOD directives and the services' instructions for identifying, tracking, and reporting advisory and assistance services costs and costs reported for other or miscellaneous services. We also (1) identified differences between current and prior years' methodology to identify advisory and assistance services; (2) compared data in DOD's Budget Reporting System with data in the advisory and assistance services' budget exhibit to Congress to determine whether such costs were properly reported in the June 1999 report to Congress; (3) obtained views from the Office of Management and Budget, DOD, and service components regarding reporting requirements and the recommendation included in the June 1999 report to Congress; and (4) obtained service headquarters and field views on the process by which the budget data for contract services was developed, including how costs were realigned from the miscellaneous service category.

We conducted our work from April 1999 through September 1999 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Honorable William S. Cohen, Secretary of Defense; Lieutenant General Henry T. Glisson, Director, Defense Logistics Agency; the Honorable Louis Caldera, Secretary of the Army; the Honorable Richard Danzig, Secretary of the Navy; and the Honorable F. Whitten Peters, Secretary of the Air Force. We will also make copies available to others on request.

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

A handwritten signature in cursive script that reads "David E. Cooper". The signature is written in black ink and is positioned above the printed name and title.

David E. Cooper
Associate Director
Defense Acquisitions Issues

Congressional Committees

The Honorable John W. Warner
Chairman
The Honorable Carl Levin
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Jerry Lewis
Chairman
The Honorable John P. Murtha
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives

The Honorable Floyd D. Spence
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on Armed Services
House of Representatives

Contract Services

Obligations for goods and services purchased by the Department of Defense (DOD) are reported using the object class structure specified in Office of Management and Budget Circular A-11. There are five major groupings of object classes in the circular: (1) personal services and benefits, (2) contractual services and supplies, (3) acquisition of assets, (4) grants and fixed charges, and (5) other. Defense contract services, as defined in the 1999 Defense Authorization Act,¹ are a subset of the contractual services and supplies category. Specifically, contract services are those contracts included in the other contractual services object class—object class 25. There are eight categories included under contract services. A brief summary of each follows.

- Advisory and assistance services—object class 25.1. Services acquired by contract from nongovernmental sources to provide management and professional support; studies, analyses, and evaluations; or engineering and technical services.
- Other services (often called miscellaneous services)—object class 25.2. Services not otherwise classified as either advisory and assistance services or any of the other service categories included under contract services—object class 25.
- Purchases of goods and services from government accounts—object class 25.3. Purchases from other government agencies or accounts that are not otherwise classified. Includes rental payments to agencies other than the General Services Administration and interagency agreements for contractual services. Excludes, among other things, advisory and assistance services obtained through interagency contracts.
- Operation and maintenance of facilities—object class 25.4. Includes the operation and maintenance of facilities, when done by contract.
- Research and development contracts—object class 25.5. Includes contractor services for conducting basic and applied research and development. Excludes research and development reported as advisory and assistance services or operation and maintenance of research and development facilities.
- Medical care—object class 25.6. Payments to contractors for medical care.
- Operation and maintenance of equipment—object class 25.7. Contractor services for operation, maintenance, repair, and storage of equipment, when done by contract. Includes storage and care of vehicles, storage of

¹Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, section 911.

household goods, and operation and maintenance of information technology systems.

- Subsistence and support of persons—object class 25.8. Contractual services with the public or another federal government agency for board, lodging, and care of persons, including prisoners.

The Office of Management and Budget defined advisory and assistance services as follows:

"Obligations for advisory and assistance services acquired by contract from non-governmental sources to support or improve organization policy development, decision-making, management, and administration; support program and/or project management and administration; provide management and support services for R&D [research and development] activities; provide engineering and technical support services; or improve the effectiveness of management processes or procedures. Such services may take the form of information, advice, opinions, alternatives, analyses, evaluations, recommendations, training, and technical support. Also includes inter-agency agreements for advisory and assistance services.

"Excludes information technology consulting services, which have large scale systems acquisition and integration or large scale software development as their primary focus—both of which are to be classified under object class 31.0 [for equipment]. Also excludes personnel appointments and advisory committees, which are classified under object class 11.3 [for other than full-time permanent personnel]. Also excludes obligations for contracts with the private sector for operation and maintenance of information technology and telecommunication services, which are to be classified under object class 25.7 [for operation and maintenance of equipment]; architectural and engineering services as defined in the Federal Acquisition Regulation...; and research on theoretical mathematics and basic medical, biological, physical, social, psychological, or other phenomena. Other contractual services classified in object classes 25.2 through 25.8, and 26.0 are excluded."

The definition further provided three categories of advisory and assistance services. They were (1) management and professional support services; (2) studies, analyses, and evaluations; and (3) engineering and technical services. In September 1998, Congress provided a new, but similar definition for each of these three categories of advisory and assistance services.² Further, the act provided that those services authorized to be exempted from reporting in the advisory and assistance service category would be those identified as exemptions in enclosure 3 of DOD Directive 4205.2 titled *Acquiring and Managing Contract Advisory and Assistance Services*, dated February 10, 1992. While many of these exemptions parallel those provided for in Office of Management and Budget Circular A-11,

²Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, section 911.

Appendix I
Contract Services

there are some differences. We were told that the Department was working to provide consistent guidance in this area.

Exemptions to Reporting Advisory and Assistance Services

The 1999 Defense Authorization Act states that there are certain authorized exemptions to reporting advisory and assistance services.¹ Specifically, the act states that

"the term 'authorized exemptions' means those exemptions authorized (as of the date of the enactment of this section) under Department of Defense Directive 4205.2, captioned 'Acquiring and Managing Contracted Advisory and Assistance Services (CAAS)' and issued by the Under Secretary of Defense for Acquisition and Technology on February 10, 1992..."

The exemptions referred to in that directive are:

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

¹ Section 911, the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999.

**Appendix II
Exemptions to Reporting Advisory and
Assistance Services**

capabilities of existing or new systems or services that are integral to the logistics support and maintenance of a system or major component and/or end item of equipment essential to the operation of the systems before final government acceptance of a complete hardware system;

- research on theoretical mathematics and basic medical, biological, physical, social, psychological, or other phenomena;
- auctioneers, realty brokers, appraisers, and surveyors; and
- services procured with funds from the Defense Environmental Restoration Account.

GAO Contacts and Staff Acknowledgments

GAO Contacts

David E. Cooper (202) 512-4841
Ralph Dawn (202) 512-4544

Acknowledgments

In addition to those named above, Marion A. Gatling, Roy Karadbil, Stephanie J. May, Maria Storts, and William T. Woods made key contributions to this report.

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