
GAO

United States General Accounting Office
High-Risk Series

February 1995

Defense Contract Management



GAO/HR-95-3



**Comptroller General
of the United States**

February 1995

The President of the Senate
The Speaker of the House of Representatives

In 1990, the General Accounting Office began a special effort to review and report on the federal program areas we considered high risk because they were especially vulnerable to waste, fraud, abuse, and mismanagement. This effort, which has been strongly supported by the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight, brought much needed focus to problems that were costing the government billions of dollars.

In December 1992, we issued a series of reports on the fundamental causes of problems in designated high-risk areas. We are updating the status of our high-risk program in this second series. Our Overview report (GAO/HR-95-1) discusses progress made in many areas, stresses the need for further action to address remaining critical problems, and introduces newly designated high-risk areas. This second series also includes a Quick Reference Guide (GAO/HR-95-2) that covers all 18 high-risk areas we have tracked over the past few years, and separate reports that detail continuing significant problems and resolution actions needed in 10 areas.

This report discusses our findings and recommendations on the significant contracting risks faced by the Department of Defense. We conclude that despite

reduced levels of defective pricing since we issued our last high-risk series report, significant contracting risks remain. Defense must continue to focus on correcting long-standing contractor cost estimating problems. Defense contractors also need to improve their procedures for identifying and excluding unallowable costs from overhead submissions. Further, Defense must immediately address very serious weaknesses in its financial controls. These weaknesses contribute to sizable and widespread overpayments to defense contractors and create the opportunity for fraudulent activities.

Copies of this report series are being sent to the President, the Republican and Democratic leadership of the Congress, congressional committee chairs and ranking minority members, all other members of the Congress, the Director of the Office of Management and Budget, and the Secretary of Defense.

A handwritten signature in black ink, reading "Charles A. Bowsher". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Charles A. Bowsher
Comptroller General
of the United States





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Overview

Reported defective contract pricing, an issue discussed in our 1992 high-risk series report, has declined significantly from a near-term high of \$919.3 million in fiscal year 1990 to \$125.5 million in fiscal year 1993—a decline of about 86 percent. At the same time, defense contractors' performance in correcting significant cost-estimating system deficiencies, which is key to sustaining a reduced risk of defective pricing, has been mixed.

Our audit work has also identified the following additional defense contracting issues as areas of high risk:

- Serious DOD financial control weaknesses have resulted in large and numerous erroneous and in some cases, fraudulent payments to defense contractors. During a 6-month period in fiscal year 1993 defense contractors returned to the government \$751 million, and in fiscal year 1994, they returned \$957 million, most of which appears to have been overpayments that were detected by the contractors.
- Weaknesses in contractor procedures for identifying and excluding unallowable costs from overhead submissions have contributed to DOD reimbursing contractors for unallowable overhead costs. During fiscal

Overview

years 1991-1993, DOD auditors questioned about \$3 billion in contractors' overhead charges.

The current emphasis on acquisition reform and the recently passed Federal Acquisition Streamlining Act of 1994 are positive steps toward strengthening the acquisition system. However, these actions can be successful only by ensuring the integrity and fairness of the procurement and contracting processes and properly protecting the government's and the taxpayers' interests.

Background

With the end of the Cold War, the nation began to reassess the threats to U.S. security interests and restructure its military capabilities. While the reassessment continues, two key facts have emerged:

- U.S. military forces and the defense industrial base that supports them have been significantly reduced.
- The economic dimension of national security is commanding increased attention.

These facts have resulted in diverse legislative and executive branch actions—all aimed at preserving a healthy and efficient defense industrial base and enhancing U.S. competitiveness. Among the more significant actions are efforts to reform defense acquisition, to encourage the use of commercial products and dual-use technologies, to convert defense firms to commercial work, and to promote defense exports.

Consistent with the reduced threat and related downsizing, DOD reduced its contracting. In fiscal year 1991, DOD reported contracting for almost \$150 billion for contractors' goods and services—nearly 2-1/2 times the combined purchases of all federal civilian agencies. Although still

Background

significant, the value of DOD contracts was reduced to around \$121 billion in fiscal year 1993.

Reduced Level of Reported Defective Pricing

Historically, a principal concern in other than fully competitive procurements has been to ensure that contractors' proposed prices are fair and reasonable. Because of the nature of the contracting process, each party attempts to protect its own constituents' interests. The contractor supports its shareholders by attempting to maximize profits, while the government protects the taxpayers by trying to ensure that contractors provide quality products at fair and reasonable prices.

In our 1992 high-risk series report, we discussed the risks associated with defectively priced contracts¹ and identified necessary actions. We pointed out that roughly one of every three audited contracts had been identified as defectively priced, and, as a result, the government paid excess costs in billions of dollars. For example, during fiscal years 1987-91, the Defense Contract Audit Agency (DCAA) reported defective prices totaling \$3.67 billion. Also, we discussed the importance of contractors' using sound cost-estimating systems to ensure that their prices are based on complete, accurate, and current data and the

¹Defective pricing occurs when a contract price is increased because the contractor has not provided complete, accurate, and current cost or pricing data. If this happens, the government can reduce the contract price.

Reduced Level of Reported Defective Pricing

need for DOD management attention to this area.

Since that time, in part as a result of reduced DOD contracting activity, the amount of reported defective pricing has declined significantly. For example, from fiscal year 1990 to fiscal year 1993, defective pricing reported by DCAA declined by about 86 percent, from \$919.3 million to \$125.5 million. While this reduction suggests a reduced level of risk for defective pricing, our recent work continues to show mixed results in terms of contractors' correcting significant deficiencies in their cost-estimating systems. Addressing significant contractor cost-estimating deficiencies continues to require DOD management attention.

Significant Cost-Estimating Deficiencies Need Continued Attention

Cost-estimating systems that produce reliable price proposals are a key safeguard to obtaining fair and reasonable contract prices. DOD administrative contracting officers are responsible for determining the adequacy of the contractors' estimating systems and, if the estimating systems are deficient, for requiring correction.

Reduced Level of Reported Defective Pricing

We recently reviewed the 30 DOD contractors that DCAA assessed as having high-risk cost-estimating systems. According to DCAA, these contractors had a total of 117 significant deficiencies in their cost-estimating systems. We found that contractors' performance in correcting these deficiencies has been mixed. Although 19 of the 30 contractors had corrected or potentially corrected² all their significant deficiencies, the remaining 11 contractors had significant uncorrected deficiencies that had been outstanding an average of 3.8 years. The failure to correct these deficiencies in a timely manner creates a variety of problems for DOD, including increased costs and delays in contract awards.

We further found that although some significant estimating deficiencies have been outstanding for years, contracting officers have been reluctant to use the strong sanctions provided by the Federal Acquisition Regulation (FAR). The contracting officers responsible for the contractors with significant uncorrected cost-estimating system deficiencies used a

²We considered deficiencies to be potentially corrected when a contractor reported that the deficiency was corrected, but the contracting officer had not yet determined the adequacy of the contractor's actions.

Reduced Level of Reported Defective Pricing

variety of approaches to get corrective action in addition to providing the contractors with DCAA's estimating system audit report and requesting that the deficiencies be corrected. However, no contracting officers took the more stringent measures allowed under regulations—reducing or suspending progress payments or recommending nonaward of potential contracts. For example, in September 1989, one contractor was reported by DCAA to have three significant cost-estimating system deficiencies: (1) not considering historically negotiated price reductions when estimating subcontract prices, (2) not providing adequate cost or pricing data to support estimated computer costs transferred from another division, and (3) not having adequate procedures to ensure that contractor estimators used appropriate cost or pricing data for estimating material and subcontract costs.

In October 1989, the contractor submitted its corrective action plan that showed the deficiencies would be corrected by February 1990. However, the contractor did not resolve these deficiencies. A joint government/contractor team, established by the contracting officer in February 1991, was

Reduced Level of Reported Defective Pricing

also unsuccessful in resolving the deficiencies. In July 1992, the contracting officer notified the contractor of the government's intent to disapprove the contractor's estimating system. According to the contracting officer, he did not, however, disapprove the system because (1) the contractor was the sole source of the items under contract and the government could not award the contract to anyone else and (2) one deficiency was in litigation. As of January 31, 1994, more than 4 years after the deficiencies were first reported, the three deficiencies remained uncorrected (one of the three deficiencies was in litigation).

When significant uncorrected estimating systems deficiencies exist, DOD officials must take extra steps to protect the government's interests. The extra steps DOD takes are frequently time-consuming and costly. For example, in December 1991, DCAA reported that a certain contractor had five significant estimating system deficiencies. DCAA first reported these deficiencies in September 1990. The deficiencies remained uncorrected when, in June 1992, the contractor submitted a \$550 million proposal to DOD that was based on costs generated by the estimating system.

Reduced Level of Reported Defective Pricing

After a substantial effort, DCAA and Army officials involved in the negotiation said they identified numerous errors in the proposal that would have significantly increased the government's costs. For example, DCAA's audit of the proposal found it to be unacceptable as a basis for negotiating a fair and reasonable price. When the contractor resubmitted data, DCAA found much of it still unacceptable. DCAA officials told us that auditing the contractor's proposal was time-consuming because they were not sure of the quality of the data submitted and needed to verify nearly all the information in the proposal. As a result, DCAA officials said they used more audit resources than normally would have been required.

Army contracting officials said they also invested considerable effort in obtaining and reviewing information from the contractor. The Army's contracting officer said the Army submitted about 100 requests to the contractor for additional information, more than twice the normal number of requests. Army contracting officials said that, because they did not trust the contractor's estimating system, reviewing the data the contractor provided was time-consuming.

Controls Over Unallowable Overhead Costs

When defense contractors bill the government for services rendered, they charge not only for the direct costs they incur but also for a portion of their overhead costs. However, not all costs incurred by defense contractors can be charged to government contracts.

The FAR contract cost principles provide the basic framework for allowable and unallowable costs. The FAR expressly states that the costs of such items as alcohol, entertainment, legislative lobbying, and donations are unallowable charges to government contracts. In other cases, the regulation is more general and does not expressly identify categories of costs as unallowable, but it uses the criteria of reasonableness and allocability in determining the nature and amount of costs that are allowable.

The regulation also clearly spells out that the contractor is responsible for establishing systems to identify and exclude unallowable costs from its overhead cost submissions. Unfortunately, these systems do not work as well as they should. Over the years, we and DCAA have questioned the allowability of billions of dollars of costs included in contractor overhead submissions.

**Controls Over Unallowable Overhead
Costs**

Our past work has shown that the inclusion of unallowable costs in contractor overhead submissions resulted in large measure from weaknesses in contractor procedures for screening for unallowable costs. Contractor procedures need to be improved. Also contributing to the inclusion of unallowable costs in contractor overhead submissions are ambiguities in the FAR and insufficient transaction testing by DCAA. In this regard, the recently enacted Federal Acquisition Streamlining Act of 1994 took a positive step to eliminate the ambiguities in the regulation's cost principles regarding the allowability of certain contractor costs. While DCAA needs to audit contracts more thoroughly than it has in the past, it may have difficulty doing this given the breadth of its workload and recent and planned staff reductions.

Weak Financial Controls Over DOD Contract Payments

Sound financial controls are critical for effectively managing contracts at DOD and for ensuring that taxpayers' funds are disbursed properly. A dramatic indicator of the adverse effects of poor controls over the disbursement process is the dollar value of payments returned to the government by defense contractors. Our work has shown that during a 6-month period in fiscal year 1993, the Defense Finance and Accounting Service (DFAS) in Columbus, Ohio—a principal DOD contract-paying activity—processed \$751 million in checks from defense contractors. Our examination of \$392 million of the \$751 million returned by contractors disclosed that about \$305 million, or about 78 percent, represented overpayments by the government. During fiscal year 1994, contractors returned an additional \$957 million. DFAS-Columbus overpaid contractors principally because it (1) paid invoices without considering previous progress payments, or (2) made duplicate payments.

Underscoring our concern about the amount of overpayments is the fact that the majority of the overpayments we examined were detected by contractors, rather than by DFAS through its controls. If the government must

**Weak Financial Controls Over DOD
Contract Payments**

rely on contractors rather than its own controls to detect and collect overpayments, the risk is greater that losses will result from undetected, or unreturned, overpayments.

The DFAS-Columbus collection process also did not ensure prompt return of overpayments identified and reported by contractors. In some cases, contractors planned to return overpayments but were told to hold them until the contracts could be reconciled and demand letters issued. The interest costs associated with these overpayments, even when they are returned, can be significant. To illustrate, for about \$240 million in returned overpayments for which we could determine the date the disbursement was made, we estimated the interest costs were about \$2.3 million.

To determine the extent of the overpayment problem, we examined nine defense contractors' records. We found that the magnitude of unreturned overpayments and uncorrected underpayments reflects a major problem requiring DOD's immediate attention. The nine contractor locations had unresolved payment discrepancies totaling about \$118 million—\$30.3 million in overpayments and \$87.7 million in underpayments. These overpayments and

**Weak Financial Controls Over DOD
Contract Payments**

underpayments result in significant unnecessary costs to the government. At current interest rates, the overpayments could cost the government about \$5,800 per day. Because the Prompt Payment Act requires DOD to pay interest on valid invoices that are paid late, the underpayments we identified could cost DOD about \$16,800 per day.

Each contractor had returned some overpayments, but the nine contractors were retaining some overpayments. Contractor officials gave several reasons for not returning overpayments; however, none of the reasons appeared to justify not returning overpayments or delaying the resolution of discrepancies. While the DFAS-Columbus office made most of the payments, other DFAS-paying offices had also made payments; some discrepancies had been outstanding for several years. DOD officials had been notified of some discrepancies but had not taken corrective action. Neither DOD nor the contractors appeared to be aggressively pursuing resolution of payment discrepancies.

DOD is currently considering ways to strengthen its existing internal control procedures to prevent overpayments and to

**Weak Financial Controls Over DOD
Contract Payments**

more rapidly detect such payments when they occur. Also, initiatives are under way to reform and streamline the complex regulatory policies and procedures that affect contract payments. Changes being considered include redesigning the progress payment process; improving the quality of contract preparation; revising a number of contract, payment, and debt collection regulations; and increasing the use of electronic data interchange for delivery, acceptance, payment, and review.

In addition, DFAS-Columbus has initiated a number of actions to correct persistent overpayment errors. These include (1) stricter adherence to operating procedures that previously had not been followed, (2) improved maintenance of the progress payment master files, (3) increased management and supervisory attention to errors and their causes, (4) increased training on how to address specific payment problems, and (5) computer systems changes such as rejecting large dollar payments if progress payments are not liquidated.

Because of the large dollar amounts at risk, DOD should view the need for corrective

**Weak Financial Controls Over DOD
Contract Payments**

actions in this area with an increased sense of urgency.

**Weak Contract
Controls Permit
Fraud**

Breakdowns in payment controls have also contributed to fraudulent payments. A case in point concerns \$3 million in false claims made by a former DOD supply officer. While the overall amount of the fraudulent payments in this case is certainly disturbing in itself, other circumstances surrounding this case may provide even more insight into the poor conditions of a key portion of DOD's internal control structure.

In this case, a former Navy supply officer, working primarily from outside Navy and DOD financial organizations, established a fictitious contracting company and received payments for over a hundred bogus invoices. Navy personnel discovered his illegal activities after he submitted several invoices for large amounts for parts purportedly delivered to a decommissioned vessel. Had the invoices not been for large sums for parts on a decommissioned vessel, he might have been able to continue to carry out his scheme.

The former supply officer carried out his illegal activities for almost 4 years because

**Weak Financial Controls Over DOD
Contract Payments**

controls were inadequate to ensure that (1) parts were ordered using authorized purchase orders, (2) parts were accepted by authorized Navy personnel, and (3) payment requests were valid. Also, the Navy did not match individual disbursements with related obligations, another control procedure that could have triggered an investigation leading to disclosure of the fraud.

The relatively unsophisticated method used to perpetrate this fraud illustrates just how weak DOD's disbursement controls are. Also, the fact that this and other cases of fraud were discovered by chance and not through internal controls raises the possibility that other schemes may be ongoing and undetected.

Billions of Dollars of
Contract
Disbursements
Cannot Be Properly
Matched to
Obligations

Matching disbursements with recorded obligations is an important control for ensuring that agency funds are used for the purposes and limitations specified by the Congress. Without such matching, there is a substantial risk that (1) fraudulent or erroneous payments may be made without being detected and (2) cumulative amounts of disbursements may exceed appropriated amounts and other legal limits.

**Weak Financial Controls Over DOD
Contract Payments**

Long-standing problems have plagued DOD's efforts to properly match disbursements with obligations. For example, in October 1994, we reported that as of June 30, 1994, DOD's records contained at least \$24.8 billion of problem disbursements.

Over the past year, DOD has taken steps to address its long-standing disbursement problems. However, correcting these problems will not be an easy task. As reported for many years, these problems are attributable to DOD's failure to practice sound financial management and the extremely poor quality of its automated contract pay and accounting systems. Unless accounting discipline and internal control practices are emphasized and enforced in the short term, DOD problem disbursements may be generated as fast as DOD can resolve them. In the long term, DOD must improve payment and accounting systems and internal control features to avoid making payments that cannot readily be matched to corresponding obligations.

Further Action Needed

While the level of reported defective pricing has been reduced with the decline in defense contracting, contractor cost-estimating systems remain an area of concern which requires continued DOD management attention. In addition, contract management risks exist because of (1) inadequate contractor procedures for identifying and excluding unallowable costs from overhead submissions and (2) poor DOD financial controls over payments to contractors.

To gain control over these troublesome problems, DOD needs to continue to emphasize to contractors the importance of expeditiously correcting deficiencies in their cost-estimating systems. DOD should persist in determining why long-standing deficiencies have not been corrected. It should also establish specific time frames for contracting officers as to when to seek guidance about using more severe remedies that are already available and when higher level management must become involved in resolving significant deficiencies.

Defense contractors and DCAA share responsibility for unallowable contract costs. While contractors need to strengthen their controls to ensure that they do not charge unallowable contract costs, DCAA

Further Action Needed

needs to improve its audits of contractors' overhead submissions. We acknowledge, however, that DCAA may have difficulty increasing audits given the scope of its workload and recent and planned staff reductions.

Top-level DOD management must also intensify its commitment to resolve contract payment disbursement problems. In the short term, DOD's efforts, including its efforts to research problem disbursement transactions and correct errors, will likely reduce the amount of erroneous and fraudulent payments and disbursements not properly matched to obligations. However, DOD will not adequately resolve its disbursement problems until it (1) corrects weaknesses in control procedures that allow problem disbursements to occur and (2) improves its contract pay and accounting systems.

Related GAO Products

Financial Management: Status of Defense Efforts to Correct Disbursement Problems
(GAO/AIMD-95-7, Oct. 5, 1994).

DOD Procurement: Overpayments and Underpayments at Selected Contractors Show Major Problem (GAO/NSIAD-94-245, Aug. 5, 1994).

Contract Pricing: DOD Management of Contractors With High Risk Cost-Estimating Systems (GAO/NSIAD-94-153, July 19, 1994).

Financial Management: Financial Control and System Weaknesses Continue to Waste DOD Resources and Undermine Operations
(GAO/T-AIMD/NSIAD-94-154, Apr. 12, 1994).

Contract Pricing: Reasons for the Decline in Reported Defective Pricing
(GAO/NSIAD-94-144BR, Apr. 11, 1994).

Overhead Costs: Unallowable and Questionable Costs Charged by E-Systems, Inc. (GAO/NSIAD-94-113, Mar. 28, 1994).

DOD Procurement: Millions in Overpayments Returned by DOD Contractors (GAO/NSIAD-94-106, Mar. 14, 1994).

Related GAO Products

Overhead Costs: Unallowable and Questionable Costs Charged by Government Contractors (GAO/T-NSIAD-94-132, Mar. 3, 1994).

Overhead Costs: Unallowable and Questionable Costs Charged by McDonnell Douglas Corporation (GAO/T-NSIAD-94-60, Oct. 13, 1993).

Financial Management: DOD Has Not Responded Effectively to Serious, Long-standing Problems (GAO/T-AIMD-93-1, July 1, 1993).

Financial Management: Navy Records Contain Billions of Dollars in Unmatched Disbursements (GAO/AFMD-93-21, June 9, 1993).

High-Risk Series: Defense Contract Pricing (GAO/HR-93-8, Dec. 1992).

1995 High-Risk Series

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