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Testimony

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GAO Contract Pricing Audits

Statement of  
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Before the  
Subcommittee on Legislation and  
National Security of the  
Committee on Government Operations  
United States House of Representatives



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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss the results of GAO's contract pricing work at selected defense contractor locations. Since 1984, GAO has assigned on an annual basis up to 70 auditors at major defense contractor locations to determine whether the Department of Defense (DOD) is negotiating fair and reasonable prices on noncompetitive contracts. DOD awarded noncompetitive contracts valued at about \$79 billion in fiscal year 1987.

In response to this subcommittee's continuing interest, we have performed several audits to determine whether (1) contractors and subcontractors complied with the Truth in Negotiations Act (Public Law 87-653) and (2) contractor estimating systems produced reliable and fully supported contract proposals. Our past and current work shows that persistent and continuing problems in both areas have caused contracts to be overpriced.

I would like to summarize the results of past GAO pricing audits and discuss recently completed audits.

#### **CONTRACTOR NONCOMPLIANCE WITH THE TRUTH IN NEGOTIATIONS ACT**

Our work shows that when contractors fail to disclose relevant cost or pricing data the government pays higher contract prices than warranted. When excessive contract prices result from nondisclosure of pertinent factual data, the government has a right to recover the overpricing pursuant to the Truth in Negotiations Act.

Congress passed the act in 1962 to protect the government against inflated contractor cost estimates. The act is intended to place the government on an informational parity with contractors by requiring contractors to submit cost or pricing data supporting proposed prices and certify that the data submitted are accurate, complete, and current. The act also provides for appropriate

contract price reductions if the data submitted is later found to be inaccurate, incomplete, or noncurrent.

To date, we have recommended price adjustments totalling \$32 million on 38 contracts because 18 major defense contractors did not disclose accurate, complete, and current cost or pricing data. DOD concurred with our recommendations and thus far has recovered \$6 million of the overpricing. Recovery action is continuing on the remaining contracts.

Pursuant to the subcommittee's request, we recently concluded work at 5 contractors and found additional potential overpricing totalling almost \$18 million. About \$13 million of the overpricing is due to noncompliance with the act and the other \$5 million is due to inadequate contractor estimating systems. The contractors generally did not agree with our findings. The contractors and amount of overpricing at each location are shown in attachment I.

I would like to discuss some of the specific problems we found during our recent effort.

At Westinghouse Marine Division, two contracts were overpriced by \$8.4 million because the company did not disclose relevant cost or pricing data on 84 of 144 material items. Specifically, the company (1) did not disclose lower vendor quotations, purchase prices, and subcontract cost analyses, and (2) made other errors that inflated proposed material prices. In addition, another Westinghouse division, supplying parts to the Marine Division, did not disclose lower material pricing information. The government, we believe, has a right to recover the overpricing under the Truth in Negotiations Act.

We also found a serious problem with Westinghouse's estimating system. Westinghouse supported its proposal to the government

with quotations which it did not intend to use to buy the material. After price agreement with the government, the company solicited and obtained additional quotations from other vendors and purchased the materials for substantially lower prices.

The government contracting officer was not aware that the company intended to solicit additional quotations. The contracting officer accepted the higher proposed prices as fair and reasonable because they were classified as competitive and he believed there would be no further negotiations between Westinghouse and its vendors. The Westinghouse practice of soliciting additional quotations, often from different vendors, at substantially lower prices after price agreement is a fundamental flaw in its estimating system. Quotations should have been solicited from all known or prospective vendors and the low bids disclosed to the government prior to price agreement.

Because Westinghouse did not obtain the second set of lower quotations for many items until after price agreement, additional overpricing of about \$5.4 million is not recoverable under the act.

The consequences of the company's material estimating practices are illustrated by the following example. Westinghouse proposed to buy a material item for about \$157,000 based on the lowest vendor quotation of \$2,378 per unit received before price agreement. The contracting officer, believing there would be no further negotiations between Westinghouse and its vendors, accepted the higher proposed price.

Shortly after price agreement, Westinghouse solicited quotations from six vendors, five of which were not solicited for government proposal purposes. Westinghouse received quotations ranging from \$1,640 to \$1,100 per unit. Based on the lower quotation,

Westinghouse bought the material for \$68,000, less than half the amount proposed and negotiated in the contract price. Thus, Westinghouse's material estimating practice caused the item to be overpriced by about \$89,000 which is not recoverable under the act.

The quotations used to support the government proposal and those used to purchase the item are shown in the following table.

Table 1: Comparison of Quotations Used to Support Westinghouse Proposal and Purchase of Material

<u>Quotations Supporting Proposal to Government</u>		<u>Quotations Used to Purchase Material</u>	
<u>Vendor</u>	<u>Unit Price</u>	<u>Vendor</u>	<u>Unit Price</u>
A	\$2,378		
B	No bid		
C	2,800	C	\$1,640
		D	1,100
		E	1,176
		F	No bid
		G	No bid
		H	No bid

At Williams International, we found a contract was overpriced by about \$1.2 million because (1) a subcontractor did not provide Williams with its most current material pricing data and (2) Williams did not disclose other material pricing data.

At Rockwell International's Missile Systems Division, the government was overcharged by about \$1 million because the company did not disclose lower prices for seven material items. Rockwell could have easily disclosed the lower prices. Additionally, as contract negotiations were concluding, Rockwell's material estimating department provided the company negotiator a one-page update showing that lower prices had been received for 3 of the 7 items. The update showed that prices for the items had decreased substantially. However, the Rockwell

negotiator did not disclose the lower prices to the government contracting officer.

At Aerojet ElectroSystems Company, we found a contract was overpriced by about \$840,000 because the company did not disclose data supporting lower labor hour estimates. About one week prior to contract price agreement, the company developed information indicating that the labor hour estimate for engineering and support systems should be reduced by about 16,000 hours. The lower estimate was supported by a 907-page computer run which included labor hours by month, workpackage, performing organization, and labor category. Aerojet did not disclose either the lower labor hour estimate or the computer run supporting the lower estimate.

At Electrospace Systems, Inc., A Chrysler Company, we found nondisclosure of labor cost data caused a contract to be overpriced by about \$1.2 million. The company represented a labor billing rate to be based on the labor mix experienced on a prior contract. The company did not disclose that it had judgmentally increased the billing rate. The contracting officer accepted the proposed billing rate as fair and reasonable. The contracting officer told us that the proposed rate would have been questioned had he known it was not the same as the company's prior experience.

Our work at Electrospace Systems was limited because the company could not produce the cost or pricing data used to support material and other labor costs negotiated in the contract. Defense contractors are contractually required to retain data used to negotiate contracts until 3 years after final contract payment. If data is not retained it precludes a determination of contractor compliance with the act.

Defense Contract Audit Agency and  
DOD Inspector General Audits

A joint contract audit effort conducted between July 1984 and September 1987 by the Defense Contract Audit Agency (DCAA) and the DOD Inspector General showed that contract overpricing was a recurring problem for 95 contractors. The audits found contract overpricing totaling almost \$790 million primarily because the contractors did not comply with the Truth in Negotiations Act. The DOD Inspector General also reported that four contractors did not retain cost or pricing data necessary for determining compliance with the act. The results led the DOD Inspector General to conclude that "the problem of defective pricing is more pernicious today than ever."

CONTRACTOR ESTIMATING DEFICIENCIES  
CONTRIBUTE TO ADDITIONAL CONTRACT OVERPRICING

Not all contract overpricing can be recovered under the Truth in Negotiations Act. Our work shows that deficient estimating systems contributed to additional overpricing of at least \$94 million. In these instances, the consequences are more serious because the government has no recovery rights under the act. Estimating systems that did not produce reliable and supportable proposals contributed to numerous overpriced contracts. Among other things, contractors (1) failed to perform subcontract cost reviews as required by DOD procurement regulations, (2) proposed vendor quotations without considering that prices paid to vendors are typically lower than quoted, and (3) relied excessively on judgment although historical data was available.

Contractors fail to evaluate subcontracts

The Federal Acquisition Regulation (FAR) requires contractors to review and evaluate prospectively-priced subcontracts of \$1 million or more and provide the evaluations to contracting

officers prior to prime contract negotiations. Contractors' failure to evaluate subcontracts can expose the government to significant overpricing.

In October 1985 testimony before your subcommittee, we reported that 26 contracts were overpriced by \$42 million because contractors, after agreeing to a price with the government, negotiated lower subcontract prices. The reductions were achieved, in large part, because contractors failed to perform the required evaluations of subcontract proposals.

In April 1987, we testified that 24 contracts were overpriced by about \$10 million because contractors did not perform the required evaluations.

Recently, we completed another audit of 8 contracts awarded to 4 contractors in 1986 and 1987 and found the problem continues. The contracts were overpriced by about \$15 million primarily because contractors did not perform required subcontract evaluations. This recent work also showed that 30 percent of the required evaluations were not completed and submitted prior to contract award. In those cases, contractors negotiated subcontract prices that were about 13 percent lower than prices negotiated in the prime contracts. When evaluations were completed and submitted as required, contractors still negotiated lower subcontract prices--but only about 4 percent lower than included in the prime contracts.

Contractors propose quotations without considering likely price reductions

Contractors often estimate material purchases of less than \$1 million on the basis of vendor quotations. Unlike major subcontracts, the FAR does not contain specific guidance on how such estimates should be developed. Our work shows that

contractors, after agreeing to prime contract prices, typically negotiated lower prices with their vendors. The contractors, however, usually did not adjust their proposals to reflect likely price reductions.

In June 1987 we reported that 78 of 108 (72%) contract proposals reviewed by DCAA during 1986 did not adjust vendor quotations to reflect reductions typically achieved in vendor negotiations. Our current effort shows the problem continues.

We reviewed 86 material purchases valued at less than \$1 million each and found that contractors negotiated prices about 8 percent lower than the prices negotiated in prime contracts. The prices proposed by contractors normally did not consider reductions likely to be achieved in vendor negotiations.

Twenty-three of the material purchases were proposed as competitive and contracting officers accepted the prices as firm believing no further negotiations would occur. Like Westinghouse, some contractors solicited additional quotations and negotiated prices significantly lower than the amounts included in prime contracts.

Contractors base estimates on judgment  
without considering historical data

In January 1988 we reported that 18 contracts were overpriced by about \$23 million because contractors relied excessively on judgment and did not consider experience from prior contracts. In some cases, the contractors had been producing the same or similar items for several years.

For example, at Raytheon we found 7 contracts were overpriced by about \$10 million because the company consistently overestimated engineering labor costs. In developing its contract proposals,

the company (1) estimated an engineering skill mix without considering actual skill mix experience from prior contracts and (2) judgmentally estimated the engineering drawings needed.

However, Raytheon actually used considerably more lower-skilled (and less costly) engineering personnel and experienced substantially fewer drawing changes than proposed and negotiated in the contracts. As a result, the company's actual engineering costs were about 33 percent lower. During our audit, Raytheon changed its estimating procedures to provide its estimators with historical skill mix data from prior contracts.

Improvements needed in  
contractor estimating systems

Our work and hearings held by your subcommittee have shown that sound cost estimating systems are fundamental to negotiating fair and reasonable contract prices. In March 1988, in response to your recommendations, DOD revised its regulatory guidance on estimating systems. Specifically, the revised regulations (1) require contractors to establish and maintain adequate estimating systems, (2) require disclosure of systems in writing, (3) provide characteristics of an adequate system, and (4) provide guidance for conducting system reviews by the government. The regulations listed contractors' failure to perform subcontract evaluations and use historical data as serious estimating deficiencies.

We support DOD's actions and believe they are excellent steps toward protecting the government's interests. Nevertheless, further improvements are needed.

In April 1987, the Deputy Assistant Secretary of Defense (Procurement) issued policy guidance defining information on reductions achieved in prior vendor negotiations as cost or

pricing data. The Deputy Assistant Secretary instructed DOD contracting officers to insist that contractors provide this data. However, the FAR does not specifically require contractors to develop and maintain historical vendor pricing information. Failure to do so is a serious estimating deficiency.

During our recent effort, we found the Air Force issued guidance requiring its contractors to develop and maintain historical vendor pricing data and furnish the data in support of proposed material prices. We believe DOD should explicitly require all contractors to develop, maintain, and furnish historical vendor pricing data.

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This concludes my statement and I will be pleased to answer any questions you or the Subcommittee may have.

## RESULTS OF RECENT GAO CONTRACT PRICING AUDITS

<u>CONTRACTOR</u>	<u>POTENTIAL OVERPRICING DUE TO</u>	
	<u>CONTRACTORS'</u> <u>NONDISCLOSURE*</u>	<u>ESTIMATING</u> <u>DEFICIENCIES</u>
Aerojet ElectroSystems Company	\$ 842,693	
ElectroSpace Systems Inc.	1,176,219	
Rockwell International Missiles Systems Division	1,008,854	
Westinghouse Marine Division	8,436,414	\$5,360,295
Williams International	<u>1,239,361</u>	<u>                    </u>
Total	<u>\$12,703,541</u>	<u>\$5,360,295</u>

\*Amounts recovered will depend on contracting officers' decisions and, possibly, litigation results.