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Briefing Report to the Chairman,
Committee on Governmental Affairs,
U.S. Senate

April 1994

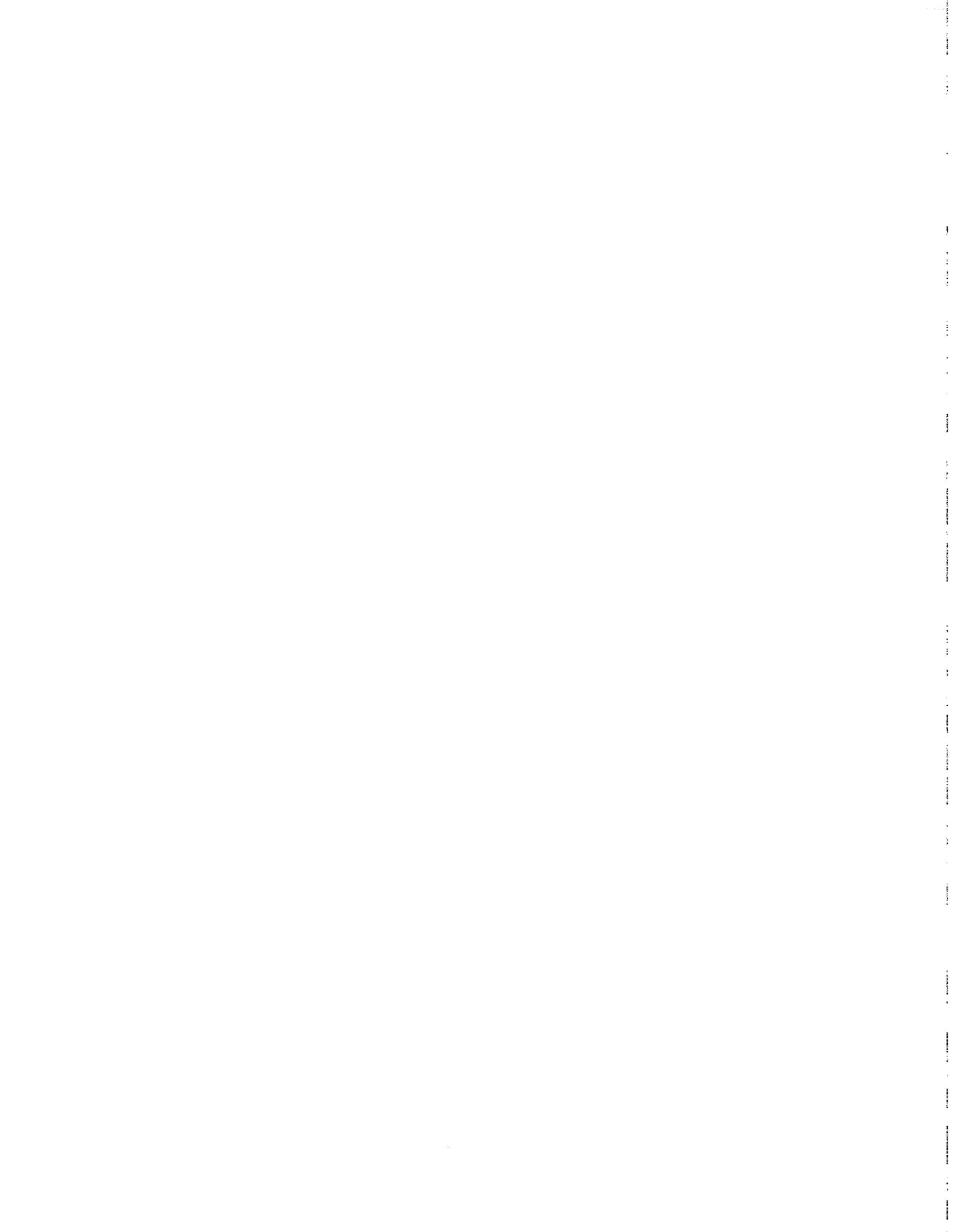
CONTRACT PRICING

Reasons for the Decline in Reported Defective Pricing



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

National Security and
International Affairs Division

B-248401

April 11, 1994

The Honorable John Glenn
Chairman, Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

In May 1992, we reported to you that the amount of potential defective pricing¹ on Department of Defense (DOD) contracts as reported by the Defense Contract Audit Agency (DCAA) had dropped for the first time in a number of years.² You asked that we determine the reason for this reduction and any further declines that might be occurring. As agreed with your staff we focused our work on the 3-year period beginning in fiscal year 1990--the peak of reported defective pricing--and ending in fiscal year 1992--the latest year for which data was available. On April 5, 1994, we briefed your staff on our work. This letter summarizes our findings, and appendix I contains the more detailed contents of our briefing.

RESULTS IN BRIEF

From fiscal year 1990 to fiscal year 1992 defective pricing reported by DCAA declined from \$919.3 million to \$273.4 million.³ Our review indicated that four main factors

¹Defective pricing occurs when a contractor or subcontractor negotiating a price, for a noncompetitive contract or subcontract anticipated to be over a specified dollar value, respectively, does not submit accurate, current, or complete data about the costs included in its proposal and, as a result, the contract or subcontract price is increased. If defective pricing is found, the government has a right to recover the amount of the overcharge.

²Contract Pricing: Status of Defective Pricing (GAO/NSIAD-92-184FS, May 21, 1992).

³In testing the accuracy of reported defective pricing for specific audits from DCAA's automated information system, we identified some errors and made corrections, resulting in adjustments to reported totals.

contributed to the decline in reported defective pricing. These are as follows:

- In fiscal year 1990, the amount of reported defective pricing was increased to a peak, in part by DCAA's completion of audits related to (1) backlogged work carried over from previous years and (2) follow-up work on contracts previously audited.
- Since fiscal year 1990, the number of contracts available to DCAA for audit has declined. This is particularly true for fixed-price contracts with values over \$100 million--the kind of contract most subject to defective pricing audits. The number of completed audits of such contracts dropped by about 61 percent between fiscal years 1990 and 1992.
- New or revised DCAA audit procedures reduced the dollar amounts reported as defective pricing. For example, starting in fiscal year 1992, DCAA auditors were required to consult with the DOD contracting officer and the contractor before finalizing their reports. As a result, the auditors had additional opportunities to obtain information that explained what could otherwise have been taken to be defective pricing.
- Improved cost-estimating systems enhanced the ability of some contractors to provide estimating information that was more accurate, current, and complete.

The first three of these factors stem mainly from changes in the level of DOD contracting and DCAA's audit activities. Only the fourth factor--improved contractor cost-estimating systems--is clearly related to contractor actions that reduce the risk of defective pricing.

Contractor cost-estimating systems provide an important control for assuring that contracts are based on accurate, complete, and current pricing data. At contractors where estimating system deficiencies are identified and corrected, the risk of defective pricing is clearly reduced. However, the decline in reported defective pricing was largely attributed, by the DCAA officials we surveyed, to the factors related to the volume of contracting or audit activity, rather than to the improvements made by contractors. We are concerned, therefore, that the risk of defective pricing has not declined as sharply as the data may indicate, and believe that improving contractor cost-estimating systems warrants DOD's continued attention.

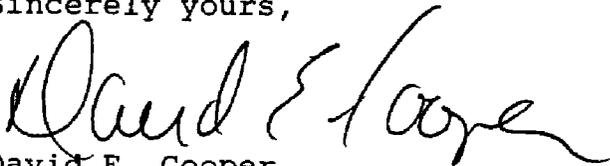
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We conducted our review between November 1992 and January 1994 in accordance with generally accepted government auditing standards. We did not obtain agency comments on our report that were fully coordinated within DOD, but we did discuss a draft of the report with DCAA officials and incorporated their comments where appropriate. Our scope and methodology are discussed in appendix II. Appendix III summarizes the importance of factors as rated by DCAA field audit office officials; appendix IV shows the trend in DCAA reported defective pricing for fiscal years 1988 to 1993.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; the Director, Office of Management and Budget; and other interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix V.

Sincerely yours,



David E. Cooper
Director, Acquisition Policy,
Technology and Competitiveness Issues

C O N T E N T S

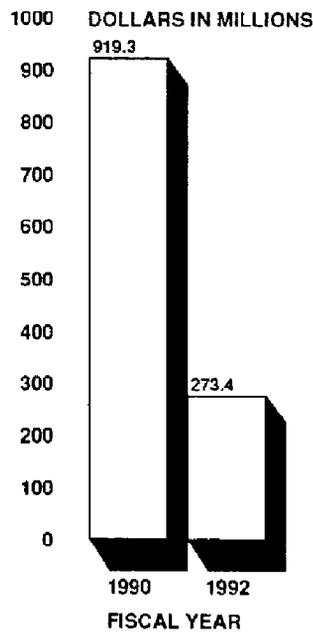
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ABBREVIATIONS

DCAA	Defense Contract Audit Agency
DOD	Department of Defense
FAO	Field Audit Office

Factors Contributing to the Decline in Defective Pricing

Reported Defective Pricing Declined Significantly



Appendix I**Factors Contributing to the Decline in Defective Pricing**

Between fiscal years 1990 and 1992, reported defective pricing declined by over 70 percent from \$919.3 million to \$273.4 million. Although the reduction in DCAA-reported defective pricing may be an indicator of greater contractor compliance with the Truth in Negotiations Act, declines in reported defective pricing could be caused by factors outside the control of the contractor. As a result, our objective was to determine the causes of the decline in defective pricing and whether that decline indicates a corresponding decline in the risk of defective pricing.

Factors Contributing to the Decline in Defective Pricing

Four main factors:

- **Defective pricing reported for fiscal year 1990 was increased by audits of backlogged and revisited contracts.**
 - **Fewer contracts were subject to audit in fiscal year 1992.**
 - **New or revised DCAA audit procedures were implemented.**
 - **Improved cost-estimating systems were used by some contractors.**
-

Causes of Increased Defective Pricing Reported for Fiscal Year 1990

Audits of:

- **Backlogged contracts carried over from previous years**
 - **Revisited contracts (contracts that had already been reviewed)**
-

Appendix I
Factors Contributing to the Decline in Defective Pricing

Audits of backlogged or revisited contracts completed in fiscal year 1990 increased the reported defective pricing for that year, thereby contributing to the drop in defective pricing by fiscal year 1992.⁴ FAOs we surveyed said that for 19 contractors completion of backlogged or revisited contract audits was a significant factor increasing fiscal year 1990 reported defective pricing. These FAOs stated that defective pricing findings for these audits amounted to \$236.8 million, about 82 percent of their total findings reported for fiscal year 1990.

DCAA headquarters officials said that the backlog of unaudited contracts built up during the late 1980s and contributed to the peaking of resources expended on defective pricing audits in fiscal year 1990. Total DCAA workyears expended for defective pricing audits peaked at 637 in fiscal year 1990, nearly a 33-percent increase over the previous year. Also, our analysis of DCAA's database confirms that a substantial amount of defective pricing (53 percent of the total) reported in fiscal year 1990 was associated with older audit assignments--an indicator of backlogged contract audits.

⁴Backlogged contracts, for defective pricing review purposes, are contracts that were mandatory selections for audit that were not completed in the fiscal year selected. They are then carried over to following years' requirements until completed or until the record retention requirements for the contract have expired.

For the purposes of our survey, a revisited contract is defined as a previously audited contract for which an FAO initiated additional defective pricing audit work that could result in newly reported defective pricing.

Fewer Contracts Subject to Audit in Fiscal Year 1992

- **Dollar value of contract proposals audited by DCAA dropped 48 percent from fiscal years 1987 to 1992.**
 - **DCAA audits of contracts over \$100 million declined 61 percent from fiscal years 1990 to 1992.**
-

Appendix I
Factors Contributing to the Decline in Defective Pricing

FAO responses to our survey indicated that a reduction in the universe of contracts available for audit led to fewer completed audits and a decline in reported defective pricing from fiscal year 1990 to fiscal year 1992. This result was consistent with the pre-survey views of DCAA headquarters officials that DOD's "down-sizing" resulted in a smaller universe of contracts available for audit, in terms of both absolute dollar value and number of contracts. They based their viewpoint, in part, on the reduction in the dollar value of DOD contract proposals DCAA audited between fiscal years 1987 and 1992. Significant declines in the dollar value of proposals available for audit can indicate significant future declines in the dollar value of contracts subject to defective pricing audits.⁵ The value of contract proposals audited by DCAA dropped from \$277.3 billion in fiscal year 1987 to \$143.3 billion in fiscal year 1992, a decrease of \$134 billion, or 48 percent. DCAA officials also said they saw an indicated decline in the absolute number of higher dollar contracts--those greater than \$10 million--based on their requirements plans for defective pricing audits for fiscal years 1991 and 1992.

⁵In fiscal year 1987, the dollar value of DCAA's contract proposal audits was \$277.3 billion and from that point declined annually through fiscal year 1992. There is a lag of up to several years from the time that contract proposals are audited, considered for negotiation, contracted, and finally available as contracts subject to defective pricing audit. Therefore, the effect of the decline in the dollar value of contract proposals audited starting in fiscal year 1988 may not be reflected in the dollar value of contracts audited for defective pricing until as late as fiscal year 1991.

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GAO analysis of DCAA's database of completed defective pricing audits indicates there was a significant reduction in the number of large contracts (those valued at over \$100 million) subject to defective pricing audit from fiscal years 1990 to 1992. DCAA policy requires that 100 percent of these large, fixed-price⁶ contracts be audited for defective pricing. The number of completed audits of these large contracts dropped by over 61 percent between fiscal years 1990 and 1992.

Analysis of DOD data indicates the drop in the number of contracts was not as extreme for contracts valued at less than \$100 million. Data from DOD's Individual Contracting Action Report (DD Form 350) indicate that for prime contractors in fiscal years 1990 to 1992, there was a 14-percent drop in the number of fixed-price contracting actions \$10 million or larger and subject to defective pricing,⁷ compared with the 61-percent drop we found for only those contracts above \$100 million that had been audited by DCAA.

⁶Our analysis included firm fixed-price and fixed-price incentive contracts, which we refer to as fixed-price contracts.

⁷In analyzing this DD Form 350 data, we included firm fixed-price and fixed-price incentive pricing actions of \$10 million or more for the 3-year period, April 1986 through March 1989, as contracting actions subject to defective pricing in fiscal year 1990. The 3-year period coincides with the general time period used by DCAA field audit offices to identify a contractor's universe of contracts available for defective pricing review. Contracts subject to audit in fiscal year 1992 covered the period April 1988 through March 1991.

New or Revised DCAA Audit Procedures

Beginning in fiscal year 1992, DCAA auditors will:

- **Obtain and analyze contractor responses to audit findings and include the responses in the audit report.**
 - **Coordinate and communicate with and request data from the DOD contracting officer during the defective pricing review.**
 - **Permit the use of cost or pricing data provided by the contractor after price agreement, but before contract award.**
-

Appendix I
Factors Contributing to the Decline in Defective Pricing

In fiscal year 1992, DCAA established several new or revised auditing procedures to help assure development of supportable defective pricing findings.⁸ The revisions were made to improve the probability that reported findings would be sustained. As a result, some findings reported as potential defective pricing under fiscal year 1990 procedures may have been resolved or retracted prior to issuing the report under fiscal year 1992 procedures.

Responses to our questionnaire showed that a majority of the FAOs surveyed believed that procedural changes contributed, at least to some extent, to the decline in reported defective pricing. Although some changes were of great importance for certain contractors, no single procedural change was dominant overall. Collectively, the changes they cited were as follows:

- obtain and analyze contractor responses to audit findings and include the responses in the audit report,
- coordinate and communicate with and request data from the DOD contracting officer during the defective pricing review, and
- permit the use of cost or pricing data provided by the contractor after price agreement, but before contract award.

⁸DCAA Contract Audit Manual, DCAAM 7640.1, Jan. 1992 Edition (Sections 14-102, 14-114, 14-115, 14-120, 14-122, and 14-123).

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Factors Contributing to the Decline in Defective Pricing

Additional coordination and communication with the contracting officer during the defective pricing review can reveal the existence of information that DCAA had not previously considered. For example, one FAO official explained how lack of coordination with the contracting officer during five audits led to withdrawing \$28 million in defective pricing reported in fiscal year 1990. In this instance, DCAA reported the \$28 million in findings because it was not aware that the subcontractor had disclosed more current data to the prime contractor (who in this case was acting as the contracting officer on the government's behalf).

One of the new audit procedures was derived from a DOD policy change permitting the use of cost or pricing data provided after price agreement, but before contract award. Near the end of negotiations, contractors may review their records to determine if the most current cost or pricing data has been disclosed to the government. These efforts are commonly referred to as defective pricing "sweeps."

In the past, some DCAA auditors have not viewed sweeps information as legitimate cost or pricing data because it was submitted to the government after price agreement. In response to DOD's policy pertaining to sweeps data, DCAA's November 1991

Appendix I
Factors Contributing to the Decline in Defective Pricing

audit guidance directed that DCAA auditors not recommend a price adjustment simply because the contractor provided sweeps data with their certification of pricing data.

Several FAOs reported that allowing sweeps data affected the 1992 decline in reported defective pricing. For example, in fiscal year 1990 DCAA reported \$22 million in defective pricing for one contractor, but, according to an FAO official, much of this amount was eventually withdrawn due to the allowance of sweeps data. By fiscal year 1992, similar findings for the contractor were not reported because implementation of the new sweeps auditing procedure invalidated the apparent defective pricing findings. As a result, reported defective pricing for the contractor dropped to zero in fiscal year 1992.

⁹The Jan. 1992 version of DCAA's Contract Audit Manual includes guidance to auditors regarding "sweeps." Paragraph 14-120.4.c. states "In situations involving sweeps, contact the contracting officer to fully understand the type of data included with the Certificate, what the contracting officer did with the data, and the effect the data had on the negotiated contract price. The auditor should not recommend a price adjustment simply because the data were provided with the certificate after price agreement because this is not defective pricing."

Improved Cost-Estimating Systems by Some Contractors

- **Some contractors improved their systems, although such improvements were cited less frequently than the first three factors.**
 - **Progress in this area results in real reductions in defective pricing and warrants continued DOD emphasis and monitoring.**
-

Appendix I
Factors Contributing to the Decline in Defective Pricing

In a DOD statement for the Senate Governmental Affairs Committee on June 4, 1992, the Director of Defense Procurement stated that "we believe the reduction in both the incidence and dollar value of defective pricing is attributable to improvements in contractor estimating systems, increased contractor accountability brought about by self-governance initiatives such as the contractor risk assessment guide program, and additional attention and resources dedicated to this issue."

The responses to our questionnaire showed that some contractors made estimating system improvements that reduced their reported defective pricing. FAOs surveyed indicated that half of the sample contractors made estimating system improvements that were of at least some importance in contributing to the decline in reported defective pricing from fiscal years 1990 to 1992.¹⁰ FAOs for nine contractors cited specific cost-estimating system improvements that were implemented in time to affect defective pricing in contracts audited in fiscal years 1991 or 1992. These nine contractors were responsible for \$114.8 million of the decline in defective pricing for the sample contractors, some portion of which was attributable to cost-estimating system improvements. However, the FAOs deemed one or more of the other factors to be of equal or greater importance at eight of these contractors. Overall, the surveyed FAO officials cited estimating system improvements less frequently than the three factors already discussed as contributing to the decline in reported defective pricing.

¹⁰See app. III for a discussion of how FAO questionnaire respondents rated the importance of each factor's contribution in causing the decline in defective pricing from fiscal years 1990 to 1992.

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Factors Contributing to the Decline in Defective Pricing

Contractor cost-estimating systems provide an important control for assuring that contracts are based on accurate, complete, and current pricing data. At contractors where estimating system deficiencies were identified and corrected, the risk of defective pricing is clearly reduced. We believe that to the extent the risk of defective pricing was reduced because contractors' cost-estimating systems were improved, real progress was made to address defective pricing. However, the decline in reported defective pricing from fiscal years 1990 to 1992 is largely attributed, by the DCAA FAOs surveyed, to factors related to the volume of contracting or audit activity, rather than the improvements made by contractors. We are concerned, therefore, that the risk of defective pricing has not declined as sharply as the fiscal year 1990 and 1992 statistics may indicate. We believe the risk of defective pricing, although diminished, continues to warrant DOD's attention, and we believe that to ensure defective pricing risk is controlled, DOD must continue to emphasize and monitor improvements in contractor estimating systems.

Scope and Methodology

- **Developed hypotheses on reasons for the decline.**
 - **Surveyed DCAA audit offices responsible for 39 contractors accounting for over two-thirds of the decline.**
 - **Conducted independent analysis of defective pricing data.**
-

Appendix II
Scope and Methodology

To determine why reported defective pricing declined between fiscal years 1990 and 1992,¹ we developed hypotheses based on (1) analysis of defective pricing audit data from DCAA's automated information system and (2) discussions with DCAA headquarters, regional, and field audit office (FAO) officials. Using this information, we developed a questionnaire and sent it to 31 DCAA field audit offices responsible for auditing the 39 contractors for which DCAA reported the largest declines in defective pricing from fiscal year 1990 to fiscal year 1992. In all, over two-thirds of the reported drop in defective pricing occurred at these 39 contractors.²

Whenever possible, we corroborated our questionnaire survey results with data from DCAA's automated defective pricing audit database, as well as with information regarding the level of contract awards from other DOD sources. Nevertheless, because the 39 contractors were judgmentally selected, the results of our

¹The results of DCAA's fiscal year 1993 defective pricing audit work were not yet available for our use when our questionnaire survey was conducted. Consequently, the universe of contractors from which our survey sample was drawn was limited to contractors with declines in reported defective pricing from fiscal year 1990 to fiscal year 1992. Information for fiscal year 1993 became available as we were completing our work. App. IV shows the defective pricing trends for fiscal years 1988-93.

²In all, 362 contractors had declines in defective pricing. The 39 we selected had declines totalling \$582 million, or 67.7 percent of the total. In making our contractor selections, we excluded the findings of six audits completed in fiscal year 1992 because they had unusually large defective pricing findings uncharacteristic of the pattern in other years.

Appendix II
Scope and Methodology

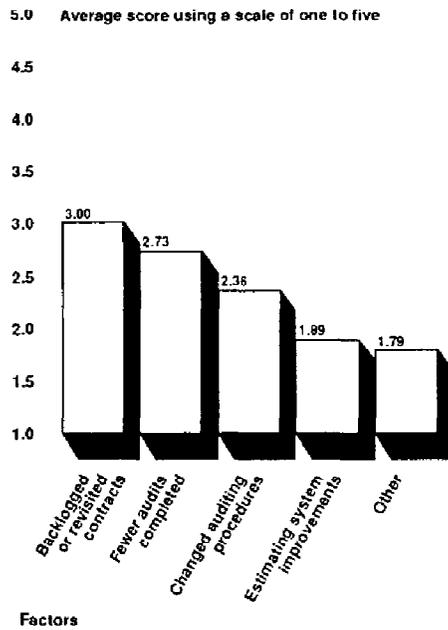
questionnaire cannot be projected to the universe of contractors that experienced declines in defective pricing from fiscal years 1990 to 1992.

We selectively tested the accuracy of defective pricing audit activity data for fiscal years 1990 to 1992 from DCAA's automated information system.³ After identifying and correcting a number of input errors in the database, we concluded that the accuracy of the corrected data for the 3-year period was sufficient for our analyses.

³We also tested the accuracy of data for fiscal years 1988, 1989, and 1993 and corrected errors to make the data useable for reporting purposes.

DCAA Field Audit Office Responses on the Importance of Factors Contributing to the Decline in Reported Defective Pricing

Figure III.1: Relative Importance of Each Factor's Contribution to the Decline in Reported Defective Pricing From Fiscal Years 1990-92.



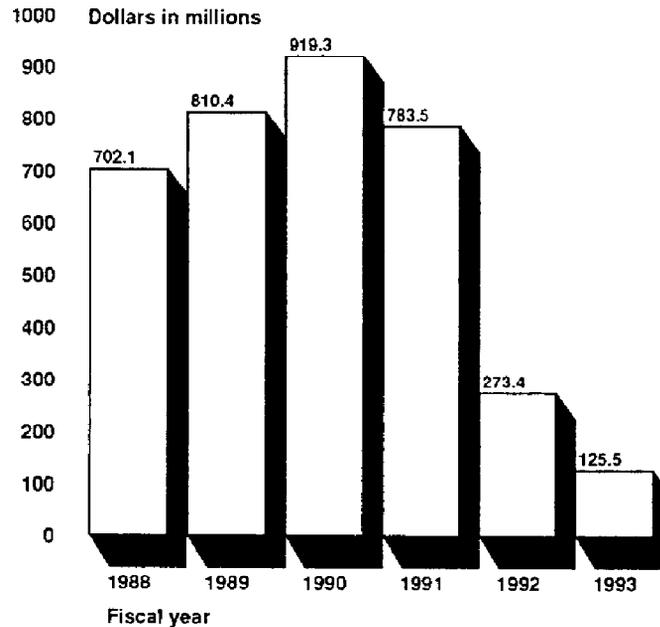
Note: The 5-point rating scale for the importance of each factor was: 1 (of little or no importance or not answered), 2 (of some importance), 3 (of moderate importance), 4 (of great importance), and 5 (of very great importance).

Appendix III
DCAA Field Audit Responses on the Importance of Factors
Contributing to the Decline in Reported Defective Pricing

In addition to the four primary contributing factors, some FAOs reported that unusual circumstances for certain contractors contributed to the decline in defective pricing (shown in fig. III.1 as a single "other" factor). For example, defective pricing reported in fiscal year 1990 for one contractor was unusually high as a result of audits completed in support of Department of Justice litigation. By fiscal year 1992, after the investigation was concluded, defective pricing levels for the contractor had declined.

Trend in Reported Defective Pricing, Fiscal Years 1988-93

Figure IV.1: Total DCAA Reported Defective Pricing Dollar Trends



Between fiscal years 1988 and 1993, DCAA reported \$3.6 billion in defective pricing. As shown in figure IV.1, defective pricing increased annually until fiscal year 1990, when it reached \$919.3 million.¹² In fiscal year 1991, a downward trend in reported defective pricing began. By fiscal year 1992 defective pricing

¹²In Contract Pricing: Status of Defective Pricing (GAO/NSIAD-92-184FS), we reported that defective pricing amounted to \$896.6 million (rather than \$919.3 million) in fiscal year 1990. The dollar amounts we reported for all fiscal years (1988-91) were lower because we excluded from our analyses audits of contracts valued under \$100,000. In this report, our analyses include such audits to assure a more complete accounting of all defective pricing identified by DCAA.

Appendix IV
Trend in Reported Defective Pricing, Fiscal Years 1988-93

declined to \$273.4 million and dropped even further to \$125.5 million in fiscal year 1993. Between fiscal years 1990 and 1993, reported defective pricing significantly declined by more than 86 percent.

In fiscal years 1991 and 1992, there were 10 audits,¹³ associated with two contractors, that were uncharacteristic of the pattern in other years because they had such unusually large defective pricing findings. The combined defective pricing for these audits amounted to 44.2 percent and 45.9 percent of the total defective pricing reported in fiscal years 1991 and 1992, respectively.

¹³We identified five subcontract audits--four in fiscal year 1991 and one in fiscal year 1992--as "outliers" due to their high amounts of defective pricing. The defective pricing for each of these audits is at least double the amount reported for any other audit during the 6-year period, fiscal years 1988-93. We also identified five prime contract audits as "outliers" because they were "add-on" audits associated with the five large outlier subcontract audits. (See GAO report GAO/NSIAD-92-184FS, app. I.)

Add-on audits are defective pricing audits that represent estimates of requirements of a DCAA prime contractor field audit office in applying add-ons (related prime contract defective pricing dollars such as overhead and profit) to subcontract defective pricing where no separate prime contract defective pricing audit is being performed.

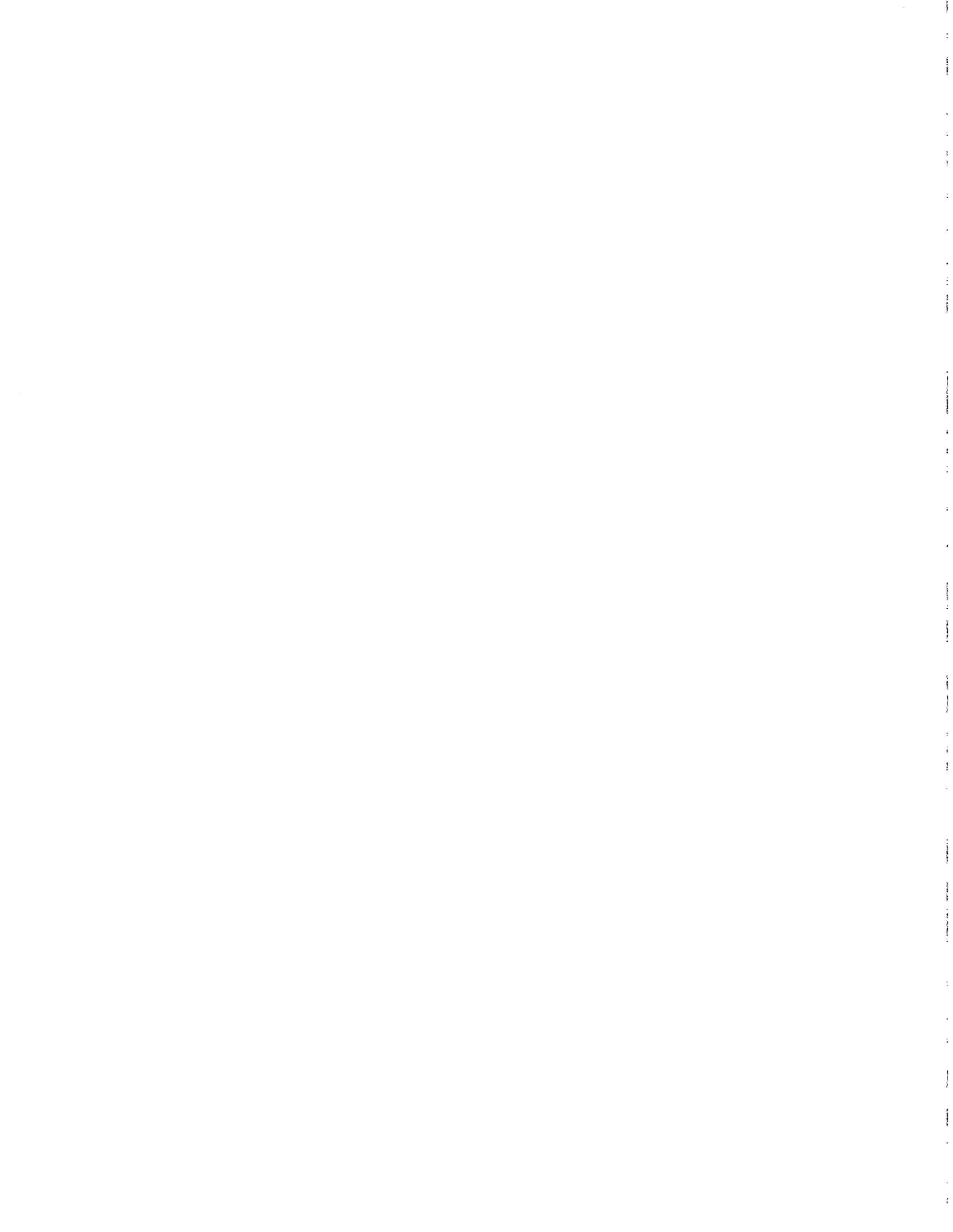
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