

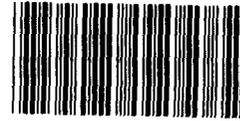
GAO

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

April 1991

CONTRACT PRICING

Inadequate Subcontract Evaluations Often Lead to Higher Government Costs



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National Security and
International Affairs Division

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April 5, 1991

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

Dear Mr. Chairman:

This report is one in a series being issued in response to your request that we evaluate the adequacy of controls for preventing fraud, waste, and mismanagement in Department of Defense (DOD) subcontracts. For this report, our objective was to determine whether recent revisions to DOD procurement regulations reduced or eliminated subcontract pricing problems that can cause inflated contract prices. We reviewed subcontract estimates in four contracts awarded to three DOD prime contractors.

Results in Brief

Despite DOD's efforts to strengthen its regulations on cost estimating systems and increase emphasis on subcontract pricing, DOD contract prices continue to be overstated because of inflated subcontract estimates. Until well-known, fundamental defects in contractor cost estimating systems are corrected, inflated subcontract estimates will continue to find their way into prime contract prices.

Our review of 68 subcontract estimates totaling about \$162 million showed that DOD paid about \$11.7 million more to three prime contractors than the contractors negotiated with their subcontractors. The excess contract prices resulted primarily because prime contractors did not evaluate noncompetitive subcontractor proposals prior to contract negotiations as required by the Federal Acquisition Regulation. Prime contractors also awarded their competitive subcontracts at prices below those negotiated in DOD prime contracts.

The Defense Contract Audit Agency (DCAA), in assessing the contractors' estimating systems, had previously cited two of the three contractors for failing to make timely evaluations of subcontract cost estimates. However, effective actions had not been taken to correct the identified system deficiencies. In addition, contracting officers responsible for awarding the contracts we reviewed did not use appropriate contract clauses to protect against inflated subcontract estimates.

Background

Subcontract costs frequently comprise more than 50 percent of prime contract values. For example, the four prime contracts considered in this review totaled about \$937 million, and about 53 percent of that total represented subcontracts and material purchases. Often, DOD and its contractors agree to a contract price before the contractor and its subcontractors agree to subcontract prices. Accordingly, DOD contract prices often contain estimates of what the subcontract prices may likely be—not the price of the actual subcontracts.

As a safeguard against inflated subcontract estimates, DOD regulations require contractors, under certain circumstances, to obtain and evaluate noncompetitive subcontract prices and include the results of the evaluations as part of their contract proposals. The key here is that such evaluations should be made before DOD and the contractor agree to a contract price because the evaluations can provide contracting officers with a basis for assuring that only fair and reasonable subcontract estimates are priced into contracts.

In past reviews, we and the DOD Inspector General had found that when contractors failed to evaluate subcontractor proposals, DOD contract prices were millions of dollars higher than warranted. In response to evidence of such subcontract pricing abuses, DOD revised its regulations and issued several policy memorandums emphasizing the need to improve subcontract pricing. According to DOD, its most significant action to address subcontract pricing problems was revising DOD procurement regulations on contractor estimating systems in March 1988.

These revised regulations require major contractors to establish and maintain systems that produce supportable and verifiable cost estimates for contract negotiations. The regulations also require that DOD regularly review the adequacy of contractors' estimating systems.

DOD administrative contracting officers are authorized to take whatever action is determined necessary to ensure that contractors correct identified deficiencies. Such actions include, but are not limited to, bringing issues to the attention of higher level management, reducing or suspending progress payments, recommending that contracts not be awarded, and ultimately, where deficiencies remain uncorrected, disapproving systems. In addition, contracting officers responsible for negotiating contracts can also delay negotiations and use contract clauses to protect against inflated contract prices.

Contractors Generally Awarded Subcontracts at Prices Substantially Below Estimates in Prime Contracts

Our review of 68 subcontract estimates totaling about \$162 million showed that the prices DOD paid its contractors were about \$11.7 million higher, including overhead and profit, than the prices the contractors paid their subcontractors.

Subcontract Evaluations Often Not Completed Prior to DOD Contract Negotiations

As part of our review, we examined 12 noncompetitive subcontract estimates, each in excess of \$1 million. We found that in the aggregate, contractors awarded these subcontracts for about \$8.8 million less than the prices negotiated in the contracts. In 9 of the 12 cases, subcontract evaluations were not completed before contract negotiations.

On one contract, the contractor did not complete required evaluations on five subcontractor proposals valued at \$59.8 million. Instead, the contractor made preliminary evaluations on four of the subcontract proposals and recommended reductions ranging from 1 to 5 percent. No preliminary evaluation was made on the fifth subcontract proposal. After DOD contract negotiations, the contractor conducted in-depth evaluations of updated proposals on the four subcontracts and recommended reductions ranging from 8 to 27 percent. Based primarily on the subsequent in-depth evaluations, the contractor negotiated average reductions of 14 percent in subcontract prices, or about \$3.1 million lower than amounts negotiated in the government contract.

The contractor told us that the preliminary evaluations complied with regulatory requirements. However, our review indicated that the preliminary evaluations did not provide assurance that the estimates were fair and reasonable. In fact, the evaluation reports themselves each contained the following qualification:

This is a preliminary analysis issued pending formal factfinding and detailed cost analysis. The opinions contained herein are based on limited data and shall not be used as a basis to undertake formal negotiations with the supplier.

Contractors Negotiated Reductions on Competitively Priced Subcontracts

In addition to achieving lower prices on noncompetitive subcontracts, prime contractors negotiated lower prices on competitive subcontracts. On 13 competitive subcontract estimates we reviewed, prime contractors negotiated subcontract prices that were about \$3 million less than amounts negotiated in DOD contracts.

In one case, involving a dual-source procurement, the DOD contracting officer requested DCAA audits of the dual-source subcontract estimates and then used the audit results to negotiate a \$5.1 million reduction in the proposed amounts. Nevertheless, after DOD contract negotiations, the contractor obtained an additional \$2 million in pricing concessions by requesting a best and final offer from the low bidder and negotiating with the high bidder on the basis of a subcontract evaluation.

In a separate report,¹ we showed that many DOD contractors did not use competitive subcontract estimates included in proposals to the government to award their subcontracts. Rather, the contractors solicited and obtained, often from different bidders, significantly lower prices before awarding their subcontracts. Contracting officers, unaware of the contractors' practice of soliciting and obtaining lower prices, accepted the estimates included in the contractors' proposals. As a result, DOD prime contracts have been overpriced by millions of dollars.

Contracting Officers Did Not Use Measures to Protect Against Inflated Estimates

DOD regulations provide measures that administrative contracting officers should take to ensure contractors take timely action to correct estimating system deficiencies such as those dealing with subcontract evaluations. Contracting officers who award contracts to contractors having identified deficiencies in their estimating systems are also responsible for using appropriate measures to protect against inflated subcontract estimates.

Two of the three contractors we reviewed had previously been cited by DCAA for subcontract evaluation deficiencies. DCAA had reported the deficiencies to DOD contract administration personnel and contracting officers responsible for contract pricing decisions. Nevertheless, the deficiencies remained uncorrected. Administrative contracting officers did not take the actions prescribed in the regulations to ensure timely correction of the deficiencies and sanctions were not used.

We found that DOD contracting officers responsible for awarding the contracts we reviewed have used pricing techniques to reduce contractors' proposed subcontract estimates. However, as evidenced by our work, the techniques were only partially successful in reducing inflated subcontract estimates. According to DOD regulations, if estimating deficiencies affect the government's ability to negotiate a fair and reasonable

¹Contract Pricing: Competitive Subcontract Price Estimates Often Overstated (GAO/NSIAD-91-149, Mar. 20, 1991).

contract price, contracting officers should consider using contract clauses that provide for adjustment of the contract price after award.

Such clauses, commonly referred to as reopener clauses, can provide an effective tool to protect against inflated subcontract estimates when contractors fail to perform required subcontract evaluations. However, on two of the prime contracts where evaluations were not completed on subcontracts valued at \$94.1 million, we found that contracting officers did not take advantage of such contract clauses.

On one of these prime contracts, the DOD contracting officer, using alternative evaluation techniques, attempted to negotiate a 15-percent reduction (\$5.1 million) to proposed subcontract estimates amounting to \$34.3 million. The contractor, however, would only concede a 5-percent reduction (\$1.7 million). A week after negotiations were completed and the contract awarded, the contractor informed the DOD contracting officer that if subsequent subcontract prices were significantly lower than those included in the contract, the savings would be voluntarily shared with the government. The contractor subsequently negotiated subcontract prices that were \$3.1 million lower, principally from subcontract evaluations completed after prime contract negotiations. The voluntary refund made by the contractor subsequently reduced the contract price by \$1.6 million.

While the voluntary refund partially accomplished the objective of a reopener clause, the contractor was under no legal obligation to share the savings. Moreover, had the DOD contracting officer used a reopener clause, the government could have realized the entire savings—not just a share. When we questioned involved DOD contracting officials about the nonuse of a reopener clause provided for in the regulations, these officials told us that it was their policy not to use such clauses. We believe this case illustrates the benefit of using reopener clauses where significant subcontract estimates are priced into prime contracts without the benefit of subcontract evaluations.

Revisions to DOD Regulations Have Not Solved the Problem

In April 1990, the DOD Inspector General reported that fiscal year 1987 DOD contracts were excessively priced by about \$94 million because, among other things, contractors failed to perform required subcontract evaluations. In response to the Inspector General's findings, DOD procurement policy officials stated:

The problems identified are not new; they have been the subject of previous GAO reports and Congressional hearings during 1987 and 1988. Regulations have already been revised and policy memoranda have already been issued to deal with the problems identified. Had the office of the IG [Inspector General] focused its review on more recent contract actions, we believe the results would have been significantly different because of the increased emphasis that has been placed on these issues during the past three years.

Since the contracts we reviewed for this report were awarded after March 1988, our review shows that DOD's actions to address subcontract pricing problems have not been effective. Moreover, in a separate report² involving estimating systems of 101 defense contractors, we demonstrate that subcontract estimating problems are pervasive.

Recommendation

We recommend that the Secretary of Defense direct contracting officials to use existing management controls and sanctions to ensure that contractors routinely comply with the subcontract pricing regulations and that subcontract prices included in DOD contracts are fair and reasonable. Contractors should be held accountable for failure to comply with such regulations and contracting officials should be held responsible for enforcing contractor compliance.

Scope and Methodology

We made our review at three major of Defense contractors, as well as DOD contracting offices responsible for awarding the contracts. We reviewed contract documents, negotiation records, price proposals and supporting data, government field pricing and cost estimating system reports, contractors' written cost estimating policies and procedures, and subcontract and purchase order file documentation.

Table 1 shows the contracts covered in our review.

²Contract Pricing: Defense Subcontract Cost Estimating Problems Are Chronic and Widespread (GAO/NSIAD-91-157, Mar. 28, 1991).

Table 1: Contracts Covered in Review

Dollars in millions

Contractor	Contract number	Contract amount	DOD buying office
Hughes Aircraft Co., Ground Systems Group, Fullerton, Calif.	N00024-89-C-6034	\$164.5	Naval Sea Systems Command, Washington, D.C.
Martin Marietta Corp., Electronics Systems, Orlando, Fla.	F33657-84-C-0004 Modification P00047	625.0	Air Force Aeronautical Systems Division, Wright-Patterson Air Force Base, Ohio
McDonnell Douglas Corp., Electronic Systems Co., Huntington Beach, Calif.	DAAJ09-88-C-A107 DAAJ09-88-C-A107 Modification P00003	77.5 69.6	Army Aviation Systems Command, St. Louis, Mo.
Total		\$936.6	

Slightly more than one-half of the total contract amount of \$936.6 million, or about \$498 million, represented the cost of subcontracts and material purchases. Of that amount, we reviewed 68 subcontracts proposed for about \$162 million.

We performed our review from June 1990 to February 1991 in accordance with generally accepted government auditing standards. As agreed, we did not obtain agency comments on this report. However, we discussed our findings with contractor representatives as well as DOD contract administration, contract audit, and buying office personnel and have incorporated their comments where appropriate.

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; Director, the Office of Management and Budget; the contractors involved in the review; and other interested congressional committees. Copies of this report will also be made available to others upon request.

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

Sincerely yours,

A handwritten signature in black ink, appearing to read "Paul F. Math". The signature is stylized with loops and a long horizontal stroke at the beginning.

Paul F. Math
Director, Research, Development,
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