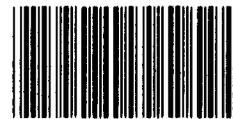


June 1992

CONTRACT PRICING

DCAA's Methodology Change in Identifying "High Risk" Contractors



146804



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RELEASE

**National Security and
International Affairs Division**

B-242859

June 2, 1992

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) contracting. We examined the new procedures used by the Defense Contract Audit Agency (DCAA) to (1) assess the degree of risk a contractor poses for overstating contract prices and (2) determine which contractors to designate as high risk for fiscal year 1992. Our objective was to determine the impact that DCAA's changes had on procedures for designating contractors as high risk.

Background

Many of DOD's contracts are for highly complex, specialized, one-of-a-kind products. They are often obtained through noncompetitive contracts. Prices for these contracts are generally determined through extensive negotiations. Recognizing the government's vulnerability to inflated contract prices in noncompetitive contracting situations, Congress passed the Truth in Negotiations Act in 1962. The act, now codified at 10 U.S.C. 2306a, requires contractors to submit data supporting their proposed prices and to certify that the submitted data are accurate, complete, and current. In the context of the act, contracts are considered to be defectively priced when a contractor negotiating a price for a noncompetitive contract does not submit accurate, complete, or current data about the costs included in its proposal and, as a result, the contract price is increased. If defective pricing is found, the government has a right to recover the amount of the increase.

DCAA is responsible for conducting audits to determine whether contractors comply with the act. Over the years, DCAA's audits have identified substantial amounts of potential defective pricing. During fiscal years 1987 through 1991, DCAA conducted defective pricing audits on contracts totaling over \$443 billion and identified potential defective pricing of about \$3.68 billion.

DCAA determines which contracts to audit through its annual assessment of the risk that major contractors pose for defective pricing. For fiscal year

1991, DCAA assessed contractors' defective pricing risk based on three factors. Based on those assessments, DCAA determined whether a contractor would be designated as high risk for defective pricing.

For fiscal year 1992, DCAA changed its assessment procedures by dropping one risk factor and adding two new ones. DCAA also changed its procedures for determining whether a contractor should be designated as high risk.

Results in Brief

The number of contractors showing high risk in at least one comparable risk factor increased from 65 in fiscal year 1991 to 96 in fiscal year 1992—48-percent increase. However, using its revised procedures, DCAA designated only 10 contractors as high risk for fiscal year 1992—an 85-percent decrease from the 65 contractors designated high risk the year before.

According to DCAA's guidance, the contractors that are not designated as high risk may be subject to less defective pricing audit coverage.

DCAA Changed Its Procedures for Designating Contractors as High Risk

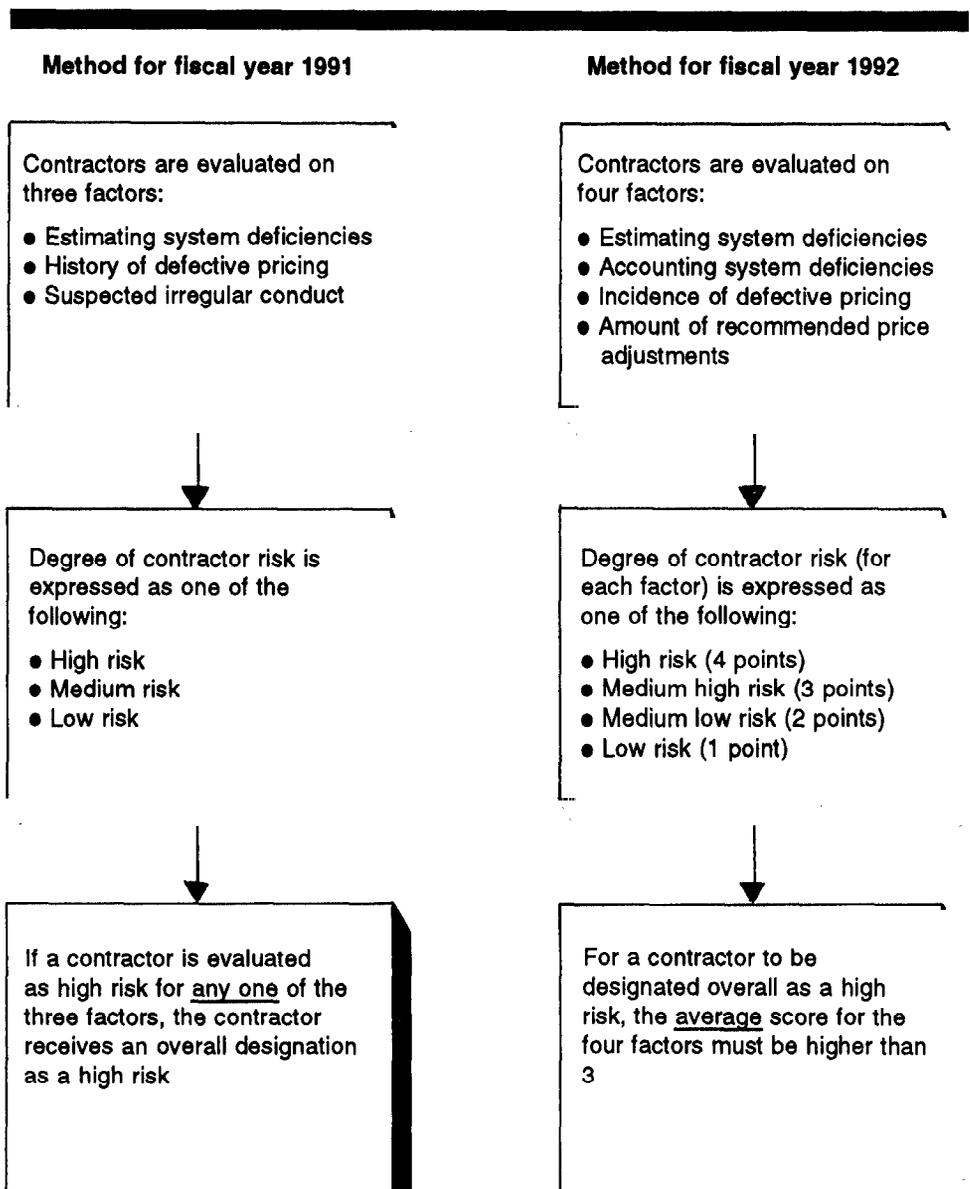
For fiscal year 1991, DCAA assessed contractors' defective pricing risk based on three factors—estimating system deficiencies, history of defective pricing, or suspected irregular conduct. For each factor, DCAA assigned one of three levels of risk—low, medium, or high. If DCAA assessed a contractor as high risk for any one of the three factors, it categorized the contractor as high risk for defective pricing.

For fiscal year 1992, DCAA changed its procedures for assessing contractor risk. First, it changed the factors by dropping one (suspected irregular conduct) and adding two new ones (accounting system deficiencies and amount of recommended price adjustments).¹ Second, it increased the levels of risk to four—low, medium low, medium high, and high. DCAA also provided specific criteria for determining the appropriate level of risk, such as specific dollar values defining the levels of risk related to recommended price adjustments; for example, greater than \$10 million for high risk and less than \$1 million for low risk. Third, DCAA changed the way it determined whether a contractor should be designated as high risk. Rather than designating a contractor as high risk based on a high-risk ranking for any one factor—as it did for fiscal year 1991—DCAA determined

¹The recommended price adjustment is the total amount a contract price increased because the contractor submitted defective cost or pricing data.

the overall risk by averaging the risk rankings in all four factors. (See fig. 1.)

Figure 1: DCAA's Methodology for Designating Contractor Risk



Source: GAO analysis of DCAA's assessment procedures.

According to DCAA, the benefits of the new assessment method include

- objective, verifiable, and consistent contractor risk determinations and
- opportunity to maximize DCAA's return on its investment in defective pricing audits by focusing on those contractors with the highest relative risk.

In addition, according to DCAA, the new method will provide incentives to contractors to improve their cost-estimating and accounting systems by showing contractors that such improvements result in fewer DCAA audits. When contractors improve, DCAA's assessment procedure will place them in a lower risk category and, depending on the dollar amount of the contracts, DCAA's audit selection criteria may result in less defective pricing audit coverage for those contractors in the lower risk categories. For example, if a contractor is considered high risk, DCAA audits all negotiated fixed-price contracts worth \$10 million to \$25 million. If the contractor is considered medium-high risk, DCAA may audit only half of these contracts.²

A detailed comparison of the criteria and methodology DCAA used in its fiscal year 1991 and 1992 contractor risk determinations is shown in appendix I.

More Contractors Show a High Risk in at Least One Factor in Fiscal Year 1992

Under the procedures it used for fiscal year 1991, DCAA designated 65 contractors as high risk for defective pricing. There were 54 contractors considered high risk because of estimating system deficiencies and 33 contractors for their defective pricing history. Because some contractors were high risk in both factors, there were 65 contractors classified as high risk in at least one factor.³

For fiscal year 1992, the number of contractors ranked high risk in at least one factor related to defective pricing or estimating system deficiencies rose considerably. DCAA considered 36 contractors as high risk for estimating systems deficiencies, 63 contractors as high risk for incidence of defective pricing, and 17 contractors for amount of recommended price

²For both high-risk and medium-high risk contractors, DCAA audits all negotiated fixed-price contracts worth \$25 million or more.

³For fiscal year 1991, DCAA also determined that some contractors presented a high risk of defective pricing because of the third factor—suspected irregular conduct. Four contractors were considered high risk because of this factor only. We excluded these contractors from our analysis in order to provide consistent comparisons between DCAA's fiscal year 1991 and 1992 procedures.

adjustments for defective pricing. DCAA determined that 96 contractors⁴—a 48-percent increase over fiscal year 1991—were a high risk for at least one of the individual factors assessed. (Some contractors were high risk in more than one factor.)

Appendixes II and III list the 96 contractors DCAA ranked as high risk for estimating system deficiencies and for history of defective pricing,⁵ respectively.

DCAA Designated Fewer Contractors as High Risk in Fiscal Year 1992

For fiscal year 1991, DCAA designated 65 contractors as high risk. Although more contractors (96) showed high risk in at least one of the comparable risk factors for fiscal year 1992, DCAA designated fewer contractors as high risk. For fiscal year 1992, DCAA designated 10 contractors as high risk—an 85-percent decrease from fiscal year 1991. (See app. V.) According to DCAA, the decrease in high-risk contractors was due to increased objectivity in making the assessments, improvements in contractor estimating and accounting systems, and fewer contractors being subject to assessment.

However, our analysis shows that the averaging calculation of the new procedure was a major reason for the decrease. For example, in fiscal year 1991, DCAA identified a contractor as high risk because of its defective pricing history. For fiscal year 1992, under the new procedure, DCAA ranked this contractor as high risk (weighted 4) for both the incidence of defective pricing and the amount of recommended price adjustments for defective pricing. DCAA ranked estimating system deficiencies as medium-high risk (weighted 3), and accounting system deficiencies low risk (weighted 1). Averaging the four factors resulted in a score of 3 and an overall designation of medium-high risk (a high-risk designation required an average score of more than 3).

The situation described in this example was not uncommon. Under the new procedure, 22 contractors were ranked high risk in 2 factors, but were not designated as high-risk contractors.

⁴For fiscal year 1992, DCAA also assessed contractors' risk of defective pricing due to accounting system deficiencies. DCAA determined that eight contractors posed a high risk due to this factor only. We excluded these contractors from our analysis in order to provide consistent comparisons between DCAA's fiscal year 1991 and 1992 procedures. The contractors that were ranked as high risk for accounting systems deficiencies are shown in appendix IV.

⁵For fiscal year 1992, contractor's history of defective pricing is broken down into two factors—the contractor's incidence of defective pricing and the amount of recommended price adjustments on the contractor's contracts.

In addition, DCAA determined that 32 of the contractors designated high risk in fiscal year 1991 were also ranked high risk for estimating systems and/or history of defective pricing in fiscal year 1992. However, under the new procedures, DCAA designated only 6 of the 32 contractors as high risk for fiscal year 1992. Of the remaining 26 contractors, 5 were designated as medium-low risk and the remaining 21 contractors were designated as medium-high risk.

Moving these 26 contractors from the high-risk category to a lower risk category may reduce DCAA's audit coverage of those contractors. According to DCAA guidance, the extent of defective pricing audit coverage for contractors is determined by the contractors' overall risk ranking and the dollar value of the contracts subject to audit. Contractors ranked medium-high risk may not be subject to the same degree of audit coverage as a contractor ranked high risk. For example, if a contractor is considered high risk, DCAA audits all negotiated fixed-price contracts worth \$10 million to \$25 million. However, if the contractor is considered medium-high risk, DCAA audits only half of these contracts.

Conclusions and Recommendation

Using its new procedures, DCAA determined that for fiscal year 1992, 96 contractors posed a high risk of defective pricing because of high risk in the evaluation factors of cost-estimating system problems and/or defective pricing history. However, because DCAA averaged the contractors' scores in the individual risk factors and classified the resulting averages over a score of 3.0 as high risk, only 10 of those contractors were actually designated as high-risk contractors for fiscal year 1992. As a result, the remaining 86 contractors could receive audit coverage that is lower than we believe is warranted by the risk of defective pricing they pose.

We recognize that DCAA must focus its audit resources on contractors with the highest relative risk. However, in our opinion, DCAA's new procedures mask the risk posed by some contractors and may result in reduced audit coverage where such reductions are not warranted, thus increasing the government's risk of defective pricing. We believe that any reduction in defective pricing audit coverage should be based on actual improvements in contractor cost-estimating systems or defective pricing history. We, therefore, recommend that the Secretary of Defense direct the Director of DCAA to revise DCAA's fiscal year 1992 procedure for designating contractors as high risk to ensure that those contractors that historically

have posed a great risk of defective pricing are included in the group of contractors that, for audit purposes, DCAA designates as high risk.

Agency Comments and Our Evaluation

In commenting on this report, DOD concurred with our findings. However, DOD did not concur with our recommendation. DOD stated that our recommendation would eliminate a significant benefit of its new procedures and could lead to development of a risk designator that was not reflective of the prevailing conditions. DOD also stated that significant improvements in a contractor's accounting and estimating systems should reduce the effect of historical deficiencies that were the cause of defective pricing; thereby, changing the current risk for contractors that have historically posed a great risk of defective pricing.

We agree with DOD that improvements in contractors' accounting and estimating systems should reduce the risk of defective pricing posed by those contractors. However, we believe that DCAA's audit coverage of those contractors should not be reduced until the effect of those improvements is demonstrated. For example, 26 contractors were not designated as high-risk contractors for fiscal year 1992, even though DCAA had designated them as high risk for 1991 and ranked them as high risk in the 1992 risk factors of history of defective pricing and/or cost-estimating system deficiencies. We believe that such contractors warrant substantial DCAA audit coverage. DOD's comments are presented in their entirety in appendix VI along with our detailed evaluation.

Scope and Methodology

Our analysis was based on DCAA's contractor risk rankings and designations for fiscal years 1991 and 1992. After reviewing the DCAA data and resolving some minor discrepancies with DCAA, we considered the data adequate for our use. We compared the DCAA instructions and criteria used in preparing the fiscal year 1991 and 1992 assessments to identify the changes resulting from the new procedures. In addition, we discussed the new procedures with DCAA field office officials and with officials located at DCAA headquarters in Washington, D.C.

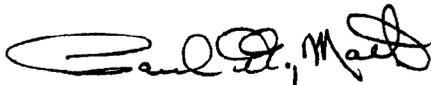
We conducted our review between January and March 1992 in accordance with generally accepted government auditing standards.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we

will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; 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) 275-8400 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix VII.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Paul F. Math". The signature is stylized with a large, sweeping initial "P" and a cursive "Math".

Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

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Abbreviations

DCAA	Defence Contract Audit Agency
DOD	Department of Defense
GAO	General Accounting Office
PASS	Postaward Audit Selection System

Criteria and Methodology Used for Fiscal Year 1991 and 1992 Contractor Risk Determinations

For fiscal year 1992, the Defense Contract Audit Agency (DCAA) revised its criteria for determining risk and its methodology for classifying contractors as to their risk of defective pricing. Similarities and differences between the fiscal year 1991 and 1992 criteria and methodology are provided below.

- Criteria:

Contractors to be assessed: DCAA did not change its criteria for identifying contractors to be assessed. The fiscal year 1991 and 1992 criteria included contractors with incurred costs of \$40 million or more for the current fiscal year on flexibly priced contracts plus those where DCAA had spent 5,000 or more hours of direct audit effort the previous year.

Information used in assessment: To assess contractor risk under the method used for fiscal year 1991, DCAA used a 3-year trend analysis of estimating system deficiencies and history of defective pricing, among other things, to assess risk. For fiscal year 1992, DCAA used these same factors but considered information from reports issued only in the last program year.

Specificity of criteria: DCAA's fiscal year 1991 criteria were general and provided little guidance for quantifying the level of risk associated with risk factors considered. For example, with respect to defective pricing, DCAA guidance stated that a low incidence of unsupported cost or defective pricing was low risk but did not specify what level of defective pricing was high risk.

DCAA's fiscal year 1992 criteria were more specific, quantifying levels of risk. For example, with respect to defective pricing history, the criteria stated an incidence of less than 15 percent was low risk and an incidence of 40 percent or more was high risk. Also, the fiscal year 1992 criteria stated that an accounting system with minor deficiencies was low risk, while a system having significant deficiencies with a cost impact of \$5 million or more was high risk.

- Methodology:

Factors used to rank contractor risk: In the fiscal year 1991 assessment, DCAA designated contractors as high risk for defective pricing because of estimating system deficiencies, a past history of defective pricing, or suspected irregular conduct by the contractor.

**Appendix I
Criteria and Methodology Used for Fiscal
Year 1991 and 1992 Contractor Risk
Determinations**

In the fiscal year 1992 assessment, DCAA considered estimating system deficiencies, the incidence of reported defective pricing, dollars of recommended price adjustments, and accounting system deficiencies in assessing a contractor's risk of defective pricing. DCAA did not consider suspected or known irregular conduct by contractors in the fiscal year 1992 assessment.

Risk rankings used to classify contractor risk: In the fiscal year 1991 assessment, DCAA used three rankings—high, medium, and low risk—to categorize contractors as to their risk for defective pricing. In the fiscal year 1992 assessment, DCAA used four rankings—high, medium high, medium low, and low risk—to classify contractors as to their risk for defective pricing.

Method used to classify contractor risk: In the fiscal year 1991 assessment, DCAA designated contractors as high risk for defective pricing based on one risk factor. In the fiscal year 1992 assessment, DCAA classified contractors as to their overall risk for defective pricing based on the average of the risk rankings assigned to the four risk factors considered. A factor ranked high risk was weighted 4, a factor ranked medium-high risk was weighted 3, a factor ranked medium-low risk was weighted 2, and a factor ranked low risk was weighted 1. A contractor with an average calculated risk of over 3 was classified as high risk for defective pricing.

Contractors DCAA Ranked as High Risk for Estimating System Deficiencies

The following are 36 contractors that, for fiscal year 1992, DCAA ranked in the high risk category for estimating system deficiencies.

- Allied-Signal Aerospace Company, Bendix Engine Controls Division
- Allison Gas Turbine Division, General Motors Corporation
- Avondale Industries Incorporated, Avondale Shipyards Division
- Ball Aerospace Systems Group, a division of Ball Corporation *
- Boeing Commercial Airplanes, a division of the Boeing Company *
- Boeing Computer Services, a division of the Boeing Company
- CACI, Incorporated
- Delco Systems Operations, a subsidiary of General Motors Corporation *
- E-Systems Incorporated, Greenville Division
- General Dynamics Corporation, Air Defense Systems Division, Pomona
- General Dynamics Corporation, Land Systems Division *
- General Electric Company, General Electric Aerospace, Ocean and Radar Systems Business, Syracuse
- General Electric Company, General Electric Aerospace Electronic Systems Department, Utica
- General Electric Company, Navy Small Steam Turbine Department, Fitchburg
- Grumman Aerospace Corporation, Grumman-Melbourne Systems Division
- ITT Federal Services Corporation
- Kaman Aerospace Corporation *
- Kaman Sciences Corporation
- Kearfott Guidance and Navigation Corporation *
- Litton Systems, Incorporated, Data Systems Division *
- Litton Systems, Incorporated, Guidance and Control Systems Division *
- Lockheed Sanders, Incorporated
- Loral Aerospace Corporation, Aeronutronic Division *
- McDonnell Douglas Helicopter Company *
- NASSCO National Steel and Shipbuilding Company
- Newport News Shipbuilding and Drydock Company *
- Nuclear Fuel Services, Incorporated
- Raytheon Company, Missile Systems Division, Lowell
- Raytheon Company, Submarine Signal Division *
- Stanford Telecommunications, Incorporated
- Tampa Shipyards, Incorporated
- Technology Application, Incorporated
- Texas Instruments, Incorporated
- Thiokol Corporation, Strategic Operations and Utah Tactical Division
- Westinghouse Electric Corporation, Marine Division *
- Westinghouse Electric Corporation, Naval Systems Division *

Appendix II
Contractors DCAA Ranked as High Risk for
Estimating System Deficiencies

Note: The asterisk indicates those contractors DCAA designated as high risk for fiscal year 1991 because of their estimating system deficiencies.

Contractors DCAA Ranked as High Risk for Defective Pricing History

The following are 71 contractors that, for fiscal year 1992, DCAA ranked in the high risk category for defective pricing history.

- AIL Systems Incorporated, a subsidiary of the Eaton Corporation
- Alliant Techsystems, Incorporated
- Allied-Signal Aerospace Company, Bendix Flight Systems Division
- Allied-Signal Aerospace Company, Bendix Oceanics Division
- Allied-Signal Aerospace Company, Bendix Test Systems Division
- Allied-Signal Aerospace Company, Garrett Auxiliary Power Division
- Allied-Signal Aerospace Company, Garrett Fluid System Division
- Atlantic Research Corporation, Aerospace Group, a unit of Sequa Corporation
- AT&T Federal Systems Business Unit
- Bath Iron Works
- Bell Helicopter Textron Incorporated
- Boeing Commercial Airplanes, a division of the Boeing Company
- Boeing Computer Support Services-Integrated Information Systems, a division of the Boeing Company
- Boeing Military Airplanes, Wichita, a division of the Boeing Company *
- CAE-Link Corporation, Link Flight Simulation Division
- Computer Sciences Corporation, Integrated Systems Division
- Control Data Corporation, Government Systems Group *
- Delco Systems Operations, a subsidiary of General Motors Corporation *
- E-Systems Incorporated, Greenville Division
- General Dynamics Corporation, Air Defense Systems Division, Pomona
- General Dynamics Corporation, Convair Division
- General Dynamics Corporation, Electric Boat Division
- General Dynamics Corporation, Electronics Division
- General Electric Company, General Electric Aerospace, Aircraft Control Systems Department, Johnson City
- General Electric Company, Aircraft Engines, Lynn
- General Electric Company, General Electric Aerospace, Defense Systems Department, Pittsfield
- Hercules Incorporated, Hercules Aerospace Company, Bacchus Plant
- Honeywell Incorporated, Military Avionics Group, Military Avionics Division, Clearwater *
- Honeywell Incorporated, Military Avionics Group, Military Avionics Division, Minneapolis
- Honeywell Incorporated, Space Systems Group, Space and Strategic Systems Operation
- Hughes Aircraft Company, Missile Systems Group, Tucson, a subsidiary of General Motors-Hughes Electronics Corporation *

**Appendix III
Contractors DCAA Ranked as High Risk for
Defective Pricing History**

- Hughes Research Laboratory, a division of Hughes Aircraft Company, a subsidiary of General Motors-Hughes Electronics Corporation
- IBM Corporation, Federal Systems Company, Owego
- IBM Corporation, Federal Systems Company, Manassas
- ITT, Aerospace Communication Division
- ITT Federal Services Corporation
- Kearfott Guidance and Navigation Corporation
- Litton Systems, Incorporated, Amecom Division *
- Lockheed Aeronautical Systems Company
- Lockheed Missiles and Space Company, Incorporated
- Loral Electro-Optical Systems, Incorporated
- Loral Aerospace Corporation, Aeronutronic Division
- Loral Corporation, Electronic Systems Division *
- McDonnell Aircraft Company, a division of McDonnell Douglas Corporation
- McDonnell Douglas Helicopter Company *
- Motorola Incorporated, Government Electronics Group *
- Northrop Corporation, Aircraft Division
- Northrop Corporation, Electronic Division
- Nuclear Fuel Services, Incorporated
- Raytheon Company, Electromagnetic Systems Division *
- Raytheon Company, Missile Systems Division, Andover
- Raytheon Company, Missile Systems Division, Tewksbury
- Raytheon Company, Submarine Signal Division
- Rockwell International Corporation, North American Aircraft
- Rockwell International Corporation, Rocketdyne Division
- Rockwell International Corporation, Satellite and Space Electronics Division
- Rockwell International Corporation, Command and Control Systems Division
- Rohr, Incorporated
- Sundstrand Power Systems, a division of Sundstrand Corporation
- Teledyne Ryan Aeronautical, a division of Teledyne Industries, Incorporated
- Teledyne Ryan Electronics, a division of Teledyne Industries, Incorporated
- Teledyne Systems Company, Incorporated *
- TRW Incorporated, Space and Defense Sector, Ballistic Missiles Division
- TRW Incorporated, Space and Defense Sector, Electronic Systems Group
- TRW Incorporated, Space and Defense Sector, Systems Development Division
- TRW Incorporated, Space and Defense Sector, Systems Engineering Division

**Appendix III
Contractors DCAA Ranked as High Risk for
Defective Pricing History**

- **Paramax Systems Corporation, a subsidiary of UNISYS Corporation, Systems Services, Northeast Region (At the time of DCAA's risk assessment, this contractor was known as UNISYS Corporation, UNISYS Defense Systems, Northeastern Division.)**
- **United Engineers and Constructors, Incorporated**
- **United Technologies Corporation, Chemical Systems Division**
- **United Technologies Corporation, Hamilton Standard Division, Space and Sea Systems**
- **Westinghouse Electric Corporation, Marine Division ***

Note: The asterisk indicates those contractors DCAA designated as high risk for fiscal year 1991 because of their history of defective pricing.

Contractors DCAA Ranked as High Risk for Accounting System Deficiencies

The following are 24 contractors that, for fiscal year 1992, DCAA ranked in the high risk category for accounting system deficiencies.

- Allied-Signal Aerospace Company, Bendix Engine Controls Division
- Ball Aerospace Systems Group, a division of Ball Corporation
- Bath Iron Works
- Boeing Aerospace and Electronics, a Division of the Boeing Company
- Boeing Military Airplanes, Seattle, a division of the Boeing Company
- Boeing Military Airplanes, Wichita, a division of the Boeing Company
- General Dynamics Corporation, Air Defense Systems Division, Pomona
- General Electric Company, General Electric Aerospace, Government Communications Systems Division, Camden
- General Electric Company, General Electric Aerospace, Government Electronic Systems Division, Cherry Hill
- General Electric Company, General Electric Aerospace, Ocean and Radar Systems Business, Syracuse
- IBM Corporation, Federal Systems Division
- ITT Federal Services Corporation
- Litton Systems, Incorporated, Data Systems Division
- Litton Systems, Incorporated, Guidance and Control Systems Division
- LTV Aerospace and Defense Company, Aircraft Division, Military Profit Center
- Massachusetts Institute of Technology
- McDonnell Douglas Helicopter Company
- NASSCO National Steel and Shipbuilding Company
- Newport News Shipbuilding and Drydock Company
- Northrop Corporation, Electronic Division
- Teledyne Ryan Aeronautical, a division of Teledyne Industries, Incorporated
- Thiokol Corporation, Space Operations and Support Services
- Thiokol Corporation, Strategic Operations and Utah Tactical Division
- Westinghouse Electric Corporation, Naval Systems Division

Contractors DCAA Designated as High Risk Based on the Average Risk Rankings

The following are 10 contractors that DCAA designated high risk for fiscal year 1992 because of their average risk rankings.

- Boeing Military Airplanes, Wichita, a division of the Boeing Company *
- General Dynamics Corporation, Air Defense Systems Division, Pomona
- Hercules Incorporated, Hercules Aerospace Company, Bacchus Plant
- Hughes Aircraft Company, Missile Systems Group, Tucson, a division of General Motors-Hughes Electronics Corporation *
- ITT Federal Services Corporation
- Kearfott Guidance and Navigation Corporation *
- Loral Aerospace Corporation, Aeronutronic Division *
- Northrop Corporation, Electronic Division
- McDonnell Douglas Helicopter Company *
- Westinghouse Electric Corporation, Marine Division *

Note: The asterisk indicates those contractors DCAA also designated as high risk for fiscal year 1991.

Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

MAY 26 1992

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "CONTRACT PRICING: DCAA's Methodology Change In Identifying "High Risk" Contractors," dated May 6, 1992 (GAO Code 396697), OSD Case 9051. The Department concurs with the report findings, but nonconcurs with the recommendation.

Detailed DoD comments in response to the recommendation are provided in the enclosure. The Department appreciates the opportunity to comment on the draft report.

Sincerely,


Alvin Tucker
Deputy Comptroller
(Management Systems)

Enclosure

Appendix VI
Comments From the Department of Defense

GAO DRAFT REPORT--DATED MAY 6, 1992
(GAO CODE 396697) OSD CASE 9051

"CONTRACT PRICING: DCAA'S METHODOLOGY CHANGE IN
IDENTIFYING "HIGH RISK" CONTRACTORS"

DEPARTMENT OF DEFENSE COMMENTS

RECOMMENDATION

RECOMMENDATION: The GAO recommended the Secretary of Defense direct the Director, Defense Contract Audit Agency, to revise the FY 1992 procedure for designating contractors as high risk to ensure those contractors that historically have posed the greatest risk of defective pricing are included in the group of contractors--which, for audit purposes, are designated as high risk. (p. 9/GAO Draft Report)

DoD RESPONSE: Nonconcur. The recommendation would eliminate a significant benefit of the current post-award audit selection system procedure and could lead to the development of a risk designator that is not reflective of the current conditions. Significant improvements in contractor accounting and estimating systems should reduce the effect of historical deficiencies that were the cause of defective pricing; thereby, changing the "current" risk of contractors that have "historically posed the greatest risk of defective pricing." For example, the recent system improvements implemented by contractors may affect the majority of the contracts in the universe for selection in the current year.

See comment 1.

The Defense Contract Audit Agency post-award audit selection system currently recognizes that any reduction in defective pricing audit coverage should result from actual improvements in the contractor cost-estimating system or defective pricing history. The post-award selection system has not reduced the amount of defective pricing reviews that the Defense Contract Audit Agency performs; in fact, the level of defective pricing effort increased from 451 man years in FY 1991 to a programmed level of 460 man years in FY 1992. It should be noted that the increase occurred while the total available resources were decreasing. Moreover, the current system is more objective than the prior system because it better documents the risk factors (e.g., estimating systems, accounting systems). The current system also requires audit managers to make more discrete risk assessments, considering four criteria, rather than the previous three.

See comment 2.

Notwithstanding its confidence in the post-award audit selection system, the Defense Contract Audit Agency will plan to gather data on the current system and perform a comparative analysis with the previous selection system. It is important to

**Appendix VI
Comments From the Department of Defense**

recognize that the current selection system has been operative for only 7 months. In addition, it should be noted that the post-award audit selection system was discussed with the Inspector General, DoD, prior to its implementation and that the Inspector General is planning a review to assess implementation as soon as it feels that one is appropriate.

The GAO identifies a reduction in the number of contractors categorized as high risk and calls this a deficiency in the post-award selection system procedures. The Department does not agree that this assessment is accurate, since it does not address the real reasons for the decline in audit risk. The draft report does not address the following, all of which reduce the Government's risk:

1. A field test that was performed to ensure the new post-award selection system did not significantly affect the number of contracts that would have been selected under the old system versus the new system. The results showed no significant difference in the number of overall selections. The current system is intended to direct audit effort to contractors where risk is greatest.

2. The hit rate on defective pricing has been on a steady decline since FY 1987, just as the total number of high risk contractors has been on a steady decline. The statistics below not only show a significant drop in the number of contractors on the high risk list in FY 1992, but also reflect a corresponding significant drop in the hit rate (FY 1991). Below are relevant Defense Contract Audit Agency statistics:

	<u>FY 87</u>	<u>FY 88</u>	<u>FY 89</u>	<u>FY 90</u>	<u>FY 91</u>	<u>FY 92</u>
Hit Rate	49%	43%	40%	35%	20%	N/A
Number of High Risk Contractors	N/A	N/A	N/A	71	65	10

3. The post-award selection system procedure identifies the fact some contractors pose a lesser degree of high risk, whereas the prior procedure did not recognize conditions that segregate truly high risk contractors from those that are implementing controls to reduce the level of risk. A more reasonable comparison is the prior year's high risk contractors (65) with the post-award selection system listing of medium-high and high risk contractors (83).

4. Although the risk assessment procedures may move a contractor to a medium high verses a high risk, so that a field audit office would only select one out of every two contracts in the \$10 - \$25 million category, the balance of contracts would remain in the universe for 3 years and would be subject to the one out of two selection criteria in subsequent years. They would be subject to 100 percent selection if the contractor's risk changed to "high risk" within the 3-year period.

See comment 3.

See comment 4.

See comment 5.

See comment 6.

See comment 7.

Appendix VI
Comments From the Department of Defense

See comment 8.

Finally, it should be noted that the FY 1991 historical information used by GAO to identify the 26 contractors responsible for 80 percent of the defective pricing for 1991 was not available when Defense Contract Audit Agency developed its high risk list for FY 1992. Using the information as part of the FY 1993 planning process, many of those contractors may be reclassified as high risk in FY 1993.

The following are our comments on the Department of Defense's (DOD) letter dated May 26, 1992.

GAO Comments

1. Improvements in contractors' accounting and estimating systems should reduce the risk of defective pricing posed by the contractors. However, we believe that DCAA's audit coverage of contractors should not be reduced until the effect of those improvements is demonstrated and the defective pricing associated with the contractors declines.

Under DCAA's new procedures—the Postaward Audit Selection System (PASS)—the defective pricing audit coverage for contractors could be reduced even though the contractors have not improved their cost-estimating systems or continue to pose a high risk of defective pricing. As discussed in this report, 26 contractors that DCAA categorized as high risk for fiscal year 1991 were not designated as high-risk contractors for fiscal year 1992, even though they were ranked as high risk in the 1992 risk factors of history of defective pricing and/or cost-estimating system deficiencies. We believe that DCAA's PASS should be revised to ensure that contractors that have historically posed the greatest risk of defective pricing are included in those designated as high risk and receive the appropriate audit coverage.

2. We agree with DOD that the PASS uses more objective criteria than DCAA's previous procedures, and we have not taken issue in this report with the number of defective pricing audits conducted or the staff resources devoted to the defective pricing area. We do raise an issue in this report regarding the potential allocation of those resources among the contractors DCAA audits. According to DCAA's guidance, contractors that are not designated high risk may receive a reduced level of audit coverage. We believe that contractors that historically pose the greatest risk of defective pricing should be included in the group of contractors that, for audit purposes, DCAA designates as high risk, and that those contractors should receive high levels of audit coverage until they demonstrate improvement.

3. We believe that the reduction in the number of contractors designated as high risk from 65 to 10 is not based upon a real reduction in defective pricing risk but results instead from the methodology used to determine the final list. We believe that the risk assessments made in the individual risk factors present a clearer picture of the government's exposure to defective pricing and the scores in those individual factors show that 96

contractors were a high risk in at least one of the three factors related to history of defective pricing and cost-estimating systems.

4. We have not raised an issue in this report regarding the total number of contracts audited. We are concerned that, as a result of the PASS procedures, DCAA's audit efforts may not be focused on the contractors that pose the greatest risk of defective pricing.

5. We agree that the average frequency of defective pricing has declined. However, the frequency of defective pricing for the high risk contractors is higher than the average. The frequency of defective pricing for the 65 contractors designated as high risk for fiscal year 1991 was 27.5 percent. The frequency of defective pricing for the 33 contractors that were designated high risk for fiscal year 1991 because of their history of defective pricing was 28.1 percent. For fiscal year 1992, DCAA ranked 63 contractors as high risk for incidence of defective pricing. The criteria for this ranking is that, based on DCAA's defective pricing audits, the contractors have a frequency of defective pricing of 40 percent or greater.

6. The comparisons in this report are based on the risk factors that were consistent from fiscal years 1991 and 1992. For fiscal year 1991, DCAA designated 54 contractors as high risk because of cost-estimating system deficiencies and 33 contractors as high risk because of their history of defective pricing. When duplicates are eliminated, the number of contractors ranked as high risk in at least one factor was 65.

Using its fiscal year 1992 PASS procedures, DCAA

- ranked 36 contractors as high risk in the cost-estimating system factor,
- ranked 63 contractors as high risk in the factor related to incidence of defective pricing, and
- ranked 17 contractors as high risk in the factor related to the dollar amount of recommended price adjustments for defective pricing.

When we eliminated the duplicates that resulted because contractors were ranked high risk in more than one factor, the net result was 96 contractors.

Comparing the 65 contractors designated high risk for 1991 to the 83 contractors on the 1992 PASS listing for the medium-high risk and high risk categories introduces a risk factor that was not addressed in 1991—accounting systems. For fiscal year 1992, 24 contractors were

ranked as high risk for accounting systems and 52 were ranked as medium-high risk.

We believe that comparing the 65 contractors for 1991 and the 96 contractors for 1992 is a valid comparison because it is focused on the contractors that were ranked in the highest risk categories for the factors that were consistent over the 2-year period. This comparison addresses contractors' implementation of controls that reduce the level of risk of defective pricing because the comparison includes the cost-estimating systems factor.

7. We recognize that contracts stay in the audit universe for 3 years. Although it is possible that DCAA's risk assessment procedures may move a contractor to a higher risk category and increase the audit coverage of its contracts, the opposite is also possible. For example, contracts with prices that are developed under poor contractor estimating systems could be subject to less audit coverage than warranted if the contractor's estimating system is later considered to have improved. A high risk cost-estimating system is characterized by having significant deficiencies, and DCAA has recommended disapproval of all or part of the system. A medium-high risk cost-estimating system is characterized by having significant deficiencies but where DCAA has not recommended disapproval of all or part of the system. If a change from a high risk cost-estimating system to a medium-high risk cost-estimating system put the contractor in a lower overall risk category, then that contractor's contracts—which may have been developed under the higher risk estimating system—would be subject to less audit coverage for defective pricing.

8. The information in this paragraph was developed from our analysis of DCAA's data for the 5 fiscal years 1987 to 1991, which is the subject of a different report (Contract Pricing: Status of Defective Pricing, GAO/NSIAD-92-184FS). The 26 contractors responsible for 80 percent of the fiscal year 1991 defective pricing are not necessarily the same 26 contractors discussed in this report.

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