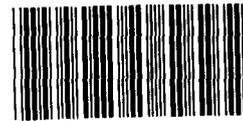


January 1991

CONTRACT PRICING

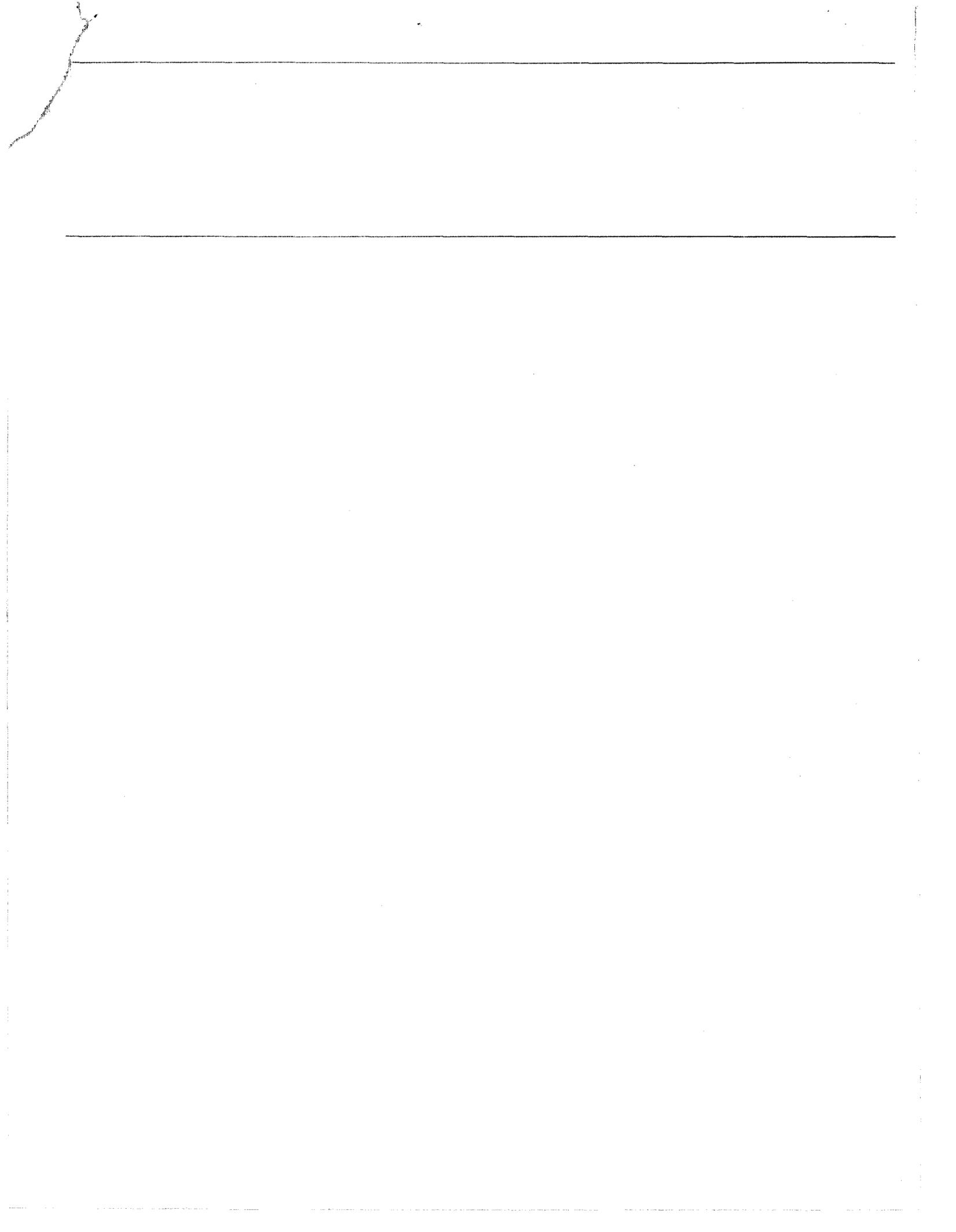
Status of DOD Defective Pricing



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**National Security and
International Affairs Division**

B-240254

January 15, 1991

The Honorable William V. Roth, Jr.
United States Senate

Dear Senator Roth:

As you requested, we obtained information on (1) the amount Department of Defense (DOD) contract prices were overstated because contractors had not complied with the Truth in Negotiations Act (P.L. 87-653) and (2) the extent to which audit recommendations in defective pricing reports were sustained during the recovery process. We also obtained information describing the DOD Inspector General's (IG) role in following up on defective pricing audits.

In the context of the Truth in Negotiations Act, contracts are considered to be defectively priced when contractors do not disclose accurate, complete, and current cost or pricing data. In resolving defective pricing audit reports, that portion of costs questioned by the auditor that is refunded to the government or credited to the government through a contract price adjustment is referred to as the "sustained amount."

This fact sheet presents information on defective pricing reported by DOD activities, the amounts sustained, and a brief description of the role of the DOD/IG in overseeing the follow-up process.

Results in Brief

DOD activities reported about \$1.7 billion in outstanding defective pricing as of September 30, 1990.¹ An additional \$319 million of defective pricing was in various stages of litigation as of September 30, 1990.

During the 3-1/2-year period from April 1, 1987, to September 30, 1990, DOD has been able to sustain a total of \$762 million, about 47 percent, of the \$1.61 billion questioned in defective pricing reports.

The DOD/IG reviews the semiannual contract audit status reports of DOD activities as part of its oversight responsibilities. During its analyses of these reports, the DOD/IG identifies areas that need special review. It has conducted a number of special reviews related to defective pricing.

¹This amount represents the amount of contract price reductions recommended by the Defense Contract Audit Agency and the Army Corps of Engineers. It does not include recommended price reductions made by the DOD/IG or the General Accounting Office.

Background

With certain exceptions, the Truth in Negotiations Act requires that contractors submit cost or pricing data to support proposed prices for non-competitive contracts. The act also requires contractors to certify that data submitted are accurate, complete, and current. When the act is applicable, the government has a right to a contract price reduction if the contracting officer determines that the contract price was overstated because the data submitted were not accurate, complete, or current.

The Defense Contract Audit Agency (DCAA) is responsible for conducting audits of contracts subject to the Truth in Negotiations Act. The objective of these defective pricing audits is to determine whether the contract price is overstated because the contractor gave the government inaccurate, incomplete, or noncurrent cost or pricing data. The DCAA conducted 5,483 such audits between July 1986 and September 1989 and found evidence of defective pricing in 45 percent, or 2,451 audits.

In resolving defective pricing audit reports, the contracting officer reviews the auditor's report, obtains a response from the contractor on the audit issues, and consults legal and technical advisers before establishing a government position on the report's recommendations. The contracting officer then negotiates a settlement with the contractor or, failing to reach agreement on the defective pricing, issues a final decision to the contractor pursuant to the disputes clause of the contract. The audit report is closed when the contractor has taken the corrective actions, including refunding or crediting negotiated price reductions, deemed necessary by the contracting officer. The amount refunded or credited to the government is the portion of the cost questioned in the audit report that is considered to be sustained.

DOD Directive 7640.2 requires DOD activities to maintain up-to-date records on the status of contract audit reports, including defective pricing reports, from receipt through disposition. The directive also requires the DOD activities to semiannually report the status of the audit reports to the DOD/IG.

Outstanding Defective Pricing

There was about \$1.7 billion in outstanding defective pricing as of September 30, 1990. Table 1 shows a breakout of the outstanding defective pricing by DOD activity.

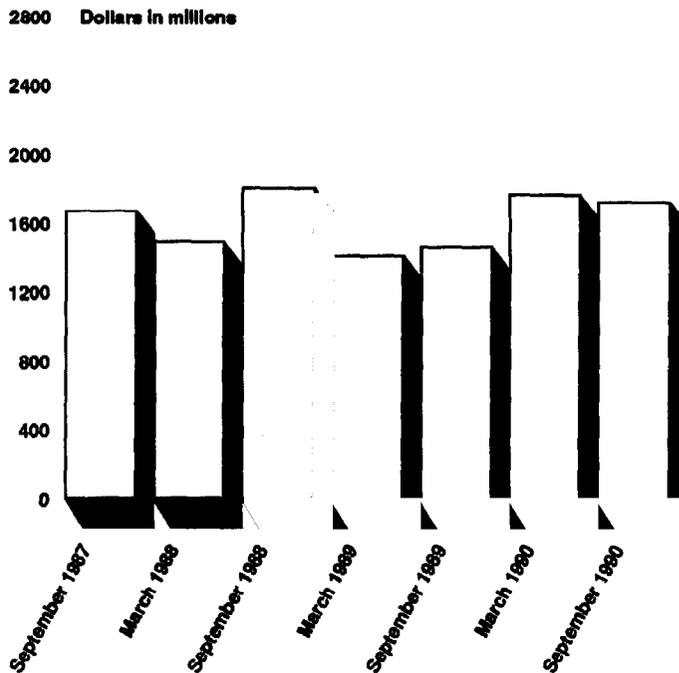
Table 1: Outstanding Defective Pricing Reported by DOD Activity (as of September 30, 1990)

Dollars in millions	
Service	Amount of defective pricing
Army	\$396
Navy	373
Air Force	836
Defence agencies	117
Total	\$1,722

Source: Office of the DOD/IG.

The DOD/IG began tracking and reporting outstanding defective pricing amounts in 1983. For the 6-month report periods between September 30, 1987, and September 30, 1990, outstanding defective pricing reported by DOD activities ranged from \$1.4 billion to \$1.8 billion, as shown in figure 1.

Figure 1: Reported Outstanding Defective Pricing

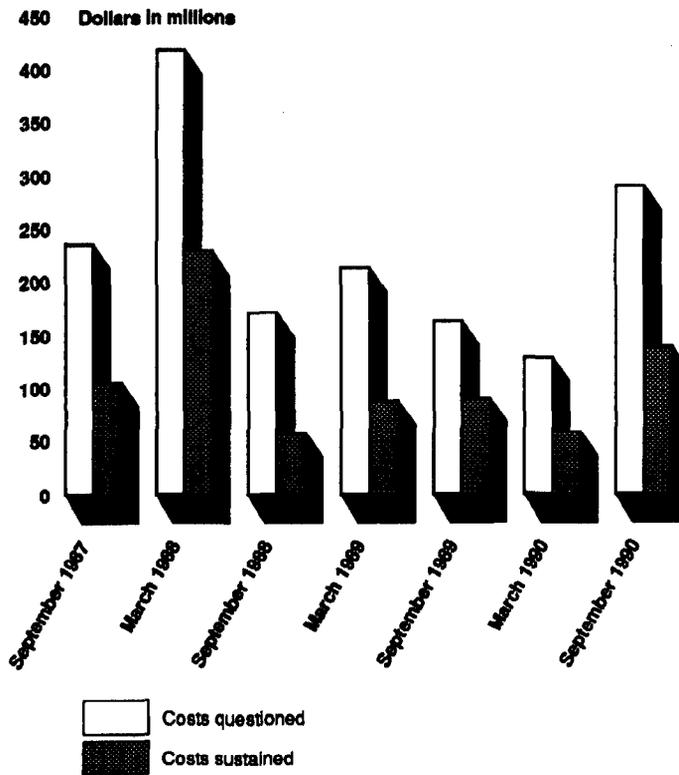


Source: Office of the DOD/IG

Sustention Rate for Defective Pricing Recommendations

The seven semiannual reports from September 30, 1987, to September 30, 1990, show that DOD was able to sustain about \$762 million of the \$1.61 billion questioned in defective pricing reports. Figure 2 shows the dollar amounts for each of the seven 6-month periods.

Figure 2: DOD-Wide Costs Questioned and Costs Sustained



Source: Office of the DOD/IG

For the 6-month period from April 1, 1990, to September 30, 1990, DOD closed 402 reports and sustained \$138 million out of the total of \$289 million questioned in the reports. The result was an average DOD-wide sustention rate of about 48 percent. Sustention rates by individual DOD activity for this period are shown in table 2.

Table 2: Sustention Rates by DOD Activity

Dollars in millions			
DOD activity	Costs questioned	Costs sustained	Percent
Army	\$15.5	\$6.9	44
Navy	87.9	26.4	30
Air Force	175.5	99.2	57
Defense agencies	10.4	5.9	57

Source: Office of the DOD/IG.

DOD/IG Oversight Role

The DOD/IG is responsible for overseeing the follow-up process for contract audit reports. As part of its oversight role, the DOD/IG reviews the DOD activities' semiannual reports, which show the status of all reportable contract audit reports, including defective pricing reports. During these reviews, the DOD/IG compiles statistics on the status of audit reports and provides information to the DOD activities on such matters as trends shown in the data the activities reported, timeliness of the activities' settlements, and sustention rates achieved.

During its analyses of the semiannual contract audit status reports, the DOD/IG also identifies areas that warrant special review, such as unusually low sustention rates on defective pricing reports. One of the reviews involved the preparation of a handbook designed to provide guidance and assistance to contracting officers in addressing defective pricing reports. In May 1990 the DOD/IG issued a "test edition" of its Truth in Negotiations Act Handbook. The handbook contains a description of the responsibilities of contracting officers; a chapter of "do's and don'ts" for contracting officers; and synopses of laws, regulations, directives, and court cases that pertain to defective pricing.

Another DOD/IG project identified and analyzed the reasons that costs questioned in defective pricing reports are not sustained. The DOD/IG's report,² issued October 11, 1990, lists the following reasons that costs questioned in audit reports are not sustained.

²Contract Audit Followup Review: Analysis of Nonsustention of Costs Questioned in Postaward Contract Audit Reports (DOD/Inspector General Report No. AFU91-1, Oct. 11, 1990).

Table 3: Reasons for Not Sustaining Questioned Costs

Reason	Percent
1. Legal opinion advised against sustention	14
2. Contractor appealed, and court or board decided issues in favor of the contractor	2
3. Audit report contained inaccurate or outdated information	10
4. Sustained amount was part of a global settlement	19
5. Contracting officer disagreed with DCAA, with well-documented rationale	20
6. Result of bottomline negotiations	12
7. Other	23

The DOD/IG also has a special review ongoing to analyze the time it takes to address defective pricing and other contract audit reports.

Scope and Methodology

The statistical information presented in this report was derived from the semiannual contract audit status reports of the DOD activities prepared for the DOD/IG for the period April 1, 1987, to September 30, 1990. We interviewed DOD contracting officials at a variety of DOD locations to gain an understanding of the problems encountered in settling defective pricing audits. The problems we identified were being addressed by the DOD/IG through its special reviews of the follow-up process. We obtained information about the work that the DOD/IG had completed, had underway, and had planned relative to the contract audit report follow-up process and discussed various aspects of this effort with DOD/IG officials.

We performed our work between November 1989 and October 1990. We did not verify or validate the information we collected. We did not obtain official written comments on this report. However, we did obtain oral comments from DOD officials, and we incorporated those comments where appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this fact sheet until 30 days after its issue date. At that time, we will send copies to the Secretary of Defense, the DOD/IG, and interested congressional committees and offices. We will also provide copies to other interested parties upon request.

David E. Cooper, Assistant Director, and John L. Carter, Assignment Manager, from our Washington, D.C., headquarters, and George C. Burdette, Evaluator-in-Charge, Mary C. Presnell, Site Senior, and Dayna L. Foster, Evaluator, from our Atlanta Regional Office developed the information for this fact sheet. Please contact me on (202) 275-4587 if you or your staff have any questions.

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 distinct "M".

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

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