STATEMENT OF

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BEFORE

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COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY

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Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to provide information on the pre-award and post-award audits of Federal Supply Schedules (FSS) proposals and contracts that the Department of Veterans Affairs (VA) manages. I will explain why pre-award and post-award audits are in the best interests of the Government and discuss the need to maintain post-award audit authority in all FSS contracts, in light of previous and current efforts to eliminate or restrict this authority.

BACKGROUND

Since 1960, VA has been delegated authority by the General Services Administration (GSA) to solicit, negotiate, award, and administer certain FSS schedules. The delegation currently encompasses eight schedules for various categories of medical/surgical supplies and equipment and pharmaceuticals, and three schedules for healthcare services. Within these schedules, VA has over 1400 active contracts in place, with annual sales exceeding $6 billion in FY 2003 and 2004. Projected sales for FY 2005 exceed $7 billion. These contracts are managed by contracting officers located at VA's National Acquisition Center (NAC) in Hines, Illinois. Although VA is the primary purchaser off these contracts, all Government agencies can use the contracts, including the Department of Defense, Bureau of Prisons, Indian Health Services, Public Health Services, and some state Veterans Homes.

Under current GSA regulation, VA has authority to conduct pre-award and post-award audits of FSS proposals and contracts. The goal of these audits is to ensure the Government receives the best possible prices. VA has a vested interest in the 11 schedules maintained by VA because approximately 60 percent of the total sales off these schedules represent VA purchases.

Prior to FY 1993, pre-award and post-award audits were conducted by the Defense Contract Audit Agency (DCAA). Based on information obtained as part of VA Office of Inspector General (OIG) oversight of the audits done by DCAA, the OIG submitted a business proposal to VA's Office of Acquisition and Materiel Management (OA&MM) showing that the audits could be conducted in a more effective and efficient manner if performed by an independent group of auditors placed under the OIG umbrella, but not paid for by OIG appropriations and not available to perform OIG oversight. This is necessary because pre-award and post-award audits are a VA program responsibility, not part of OIG oversight activities under the Inspector General Act.

In FY 1993, OA&MM entered into a Memorandum of Understanding with the OIG for the Contract Review and Evaluation Division (Division) to provide these services on a reimbursable basis, paid for by VA's Revolving Supply Fund under the provisions of the Economy in Government Act. The Division functions as a group separate and distinct from OIG operations. The reimbursable funds are not used to conduct OIG oversight activities of VA programs and operations. The Revolving Supply Fund was established for the operation and maintenance of VA's supply system. The FSS is part of that system.

This partnership with VA has proven to be very successful. During the past 12 years, the Division has conducted 240 pre-award audits which resulted in recommendations for better use of funds in the amount of approximately $2.2 billion. Of this recommended amount, more than $390 million has been sustained during contract negotiations, which represents 40 percent of the recommendations for better use of funds in those contracts that have been awarded. In addition, 238 post-award audits were conducted, resulting in approximately $319 million in recoveries for VA. A majority of the funds recovered were returned back to the VA Revolving Supply Fund, which greatly exceeds the reimbursable operational costs for the Division.

Of the 238 post-award audits, 107 were initiated in response to the vendor's voluntary disclosures. In their disclosures, these vendors collectively offered to pay back $37.5 million in overcharges; however, as a result of post-award audits, the Division actually recovered $113 million. The number of voluntary disclosures shows that post-award audit authority has had a deterrent effect on industry, which is one of the primary purposes of having the authority to conduct these audits. In addition to the monetary benefits, these audits provide valuable insight into each vendor's commercial practices, which VA has used to improve its contracting and purchasing activities.

FSS PROGRAM

The FSS program is unique because it allows vendors the opportunity to non-competitively enter into a contract to offer their entire product line to the Government. Because the contracts are awarded without competition, and in order to ensure prices are fair and reasonable, prices are negotiated by comparing the prices and incentives offered to the Government to those offered to the vendor's commercial (non-Government) customers. The Government's negotiation objective is to obtain prices that are equal to or better than the vendor's Most Favored Customer (MFC). The MFC is the lowest net price the vendor offers its commercial customers, taking into consideration discounts and other incentives, such as rebates, free goods, trade-ins, etc.

When a proposal for a contract or request for modification to add products to an existing contract is submitted, vendors are required to provide VA with specific information regarding their Commercial Sales Practices (CSP) and to state whether the prices offered are equal to or less than MFC. CSP information identifies the vendor's best commercial customers, the discounts off list price those customers receive, and any programs or incentives that commercial customers are offered which may result in lower net prices. The Government relies on CSP information to determine whether offered prices are fair and reasonable. If the vendor supplies pricing information that is not accurate, complete, and current, the Government can end up paying more for products than similarly situated commercial customers.

Another pricing feature of FSS contracts is the Price Reductions Clause. The purpose of the clause is to ensure that the Government maintains fair and reasonable pricing throughout the term of the contract. VA relies on the CSP data provided by the vendor to identify one or more commercial customers as tracking customers. During the term of the contract any additional discounts or incentives offered to the tracking customers also must be offered to the Government.

Pre-award audits assist contracting officers in selecting the tracking customers and post-award audits monitor compliance with the Price Reductions Clause.

<u>Pre-Award Audits</u>

The primary purpose of a pre-award audit is to evaluate the CSP information provided by the vendor and determine whether offered prices are fair and reasonable. These audits provide advice to contracting officers on negotiation strategies, other issues that may affect the decision to award or non-award a contract or individual line items, the selection of tracking customers for purposes of the Price Reductions Clause, and Government purchasing practices that may impact negotiations. Under current VA policy, pre-award audits are required on pharmaceutical FSS offers with estimated annual sales of $5 million or greater and for all other FSS offers with expected annual sales of $3 million or greater.

Post-Award Audits

Post-award audits are conducted after the award of a contract or contract modification. The audit includes the verification of CSP information provided prior to the award or modification of a contract if a pre-award was not conducted. A post-award also includes a review of whether the vendor has complied with the Price Reductions Clause, whether Government customers were charged more than the contract price, and whether sales were accurately reported as required under the terms of the contract.

Post-award audits can be initiated by the Division, requested by the VA contracting officer, or conducted in response to a vendor's voluntary disclosure. In the past 8 years, the majority of our post-award audits have been initiated in response to voluntary disclosures. In addition, some post-award audits are initiated in response to civil complaints filed in a United States District Court pursuant to the *qui tam* provisions of the False Claims Act. Post-award audits result in the adjustment of contract prices and the collection of overcharges. Out of the 238 post-award audits conducted, all but one was settled without the need for litigation. The VA Board of Contract Appeals ruled for the VA on the one remaining claim.

Pre-award audits of CSP information are preferable to post-award audits because they impact on decisions that affect contract prices at the time of award. In addition to the resulting up-front cost savings, pre-award audits reduce the need to identify, calculate, and collect overcharges. However, post-award audits are the only vehicle available to monitor compliance with the Price Reductions Clause and other contract terms and conditions. There are not sufficient resources to conduct pre-award audits of all proposals, and requests for modifications to add new products to a contract rarely undergo a pre-award audit because they do not reach the dollar threshold triggering such audits. This is significant because it is a common practice for vendors to submit requests for modification to add items to an existing FSS contract. Through modifications, vendors can add thousands of line items that can significantly increase the value of the contract. For example, a recent review by the Division of FSS contract files identified a contract that was modified 10 times in the 16 months after award. Seven of the 10 modifications added over 1200 line items to the contract.

POST-AWARD AUDIT RIGHTS

In 1995, GSA began the process of amending the Federal Acquisition Regulation (FAR) to implement the provisions of the Federal Acquisition Streamlining Act of 1994 (FASA), which affected the Truth in Negotiations Act and the acquisition of commercial items, and the Clinger-Cohen Act of 1996. With respect to the FSS program, GSA's intent was to reinvent the program to move to a future environment of greater use of commercial practices, increased competition, and greater responsibility in making smart buying decisions.

Although post-award audits were not specifically addressed in FASA or the Clinger-Cohen Act, the issue was subject to much debate. This was due in great part to a move

by industry to have the post-award audit and access to records provisions eliminated from FSS contracts, particularly with respect to information provided in support of negotiations prior to award or contract modifications. Although GSA had no objection to eliminating these provisions, such action was opposed by VA, VA OIG, GSA OIG, and the Department of Justice. After considerable discussion among GSA, the Office of Management and Budget (OMB), and the Government entities opposing the changes, GSA published its Final Rule on August 21, 1997.

The Final Rule eliminated the contract clause that automatically provided post-award audit rights for pricing information in every FSS contract, including those maintained by VA. Although the new rule provided the contracting officer the opportunity to modify the Examination of Records by GSA (Multiple Award Schedule) clause to provide for post-award access to records, it permitted verification of the pre-award/modification pricing, sales, and other data submitted, which related to supplies or services offered under the contract. This modification could only be made after the contracting officer determined that there was a likelihood of significant harm to the Government without the authority to verify information and only after the contracting officer obtained the approval of the Senior Procurement Executive at VA or GSA that the contracts were at risk. However, as a compromise with industry, the Final Rule also imposed a 2-year limitation on auditing commercial sales practice and other information relied on by the contracting officer in awarding a contract or modification. In response to the Final Rule, VA evaluated its schedules, identified those that were at risk, and took the actions necessary to include the post-award examination of records clause in those schedules.

In implementing the Final Rule, GSA stated that it expected to shift its emphasis to pre-award audits of pricing information. In compliance with GSA's intent, VA placed a greater emphasis on pre-award audits through a policy that mandates pre-award audits of proposals based on specific dollar thresholds. Of note, however, a report issued by the Government Accountability Office (GAO) in February 2005, *Contract Management — Opportunities to Improve Pricing of GSA Multiple Award Schedules Contracts*, revealed that GSA did not shift its focus to pre-award audits; rather very few audits were conducted at all.

In FY 1999, the Government Electronics & Information Technology Association (GEIA) submitted a petition to OMB, Office of Federal Procurement Policy (OFPP) under the provisions of Section 25(c) of the Office of Federal Procurement Policy Act, challenging these provisions in the Final Rule. The petition was denied based on OFPP's determination that the practices and their use were in concert with the FAR requirement to be consistent with customary commercial practice to the "maximum extent practicable."

On March 11, 2005, GSA published an Advance Notice of Proposed Rulemaking (Advance Notice) requesting comments on several issues, including the right to examine contractor records after contract award. GSA stated in an April 12, 2005, amendment to the Advanced Notice that it had questions as to how the taxpayer might benefit from any revisions to the General Services Administration Acquisition Regulation (GSAR) to

address contractor concerns regarding post-award audits. GSA stated that it was interested in exploring whether GSA should modify the Examination of Records clause at GSAR 552.215-71 to reinstate the pre-August 1997 post-award audit rights clause and the right to examine records to verify that pre-award/modification pricing, sales, and other data was accurate, complete, and current. The Advance Notice stated that the major concerns raised by industry with respect to the post-award audit authority included complaints that the audits are too broad and are not consistent with commercial contract practices.

VA and VA OIG submitted joint comments in response to the Advance Notice. We advised GSA that it would be in the best interest of the Government to modify the Examination of Records clause at GSAR 552.215-71 to reinstate the post-award access to records and right to examine records clause that was deleted by GSA's August 21, 1997, Final Rule. One position supporting the need to reinstate the prior clause is that if GSA initiates post-award audits under the current Final Rule, it may have a negative impact on VA's post-award audit program.

The August 21, 1997, Final Rule deleted the clause that permitted post-award examination of records for the purpose of auditing pricing information, but it allowed the awarding agency some discretion to include the clause in schedules that were determined to be at risk for harm if the clause was not included. However, the Final Rule states that "GSA anticipates that such instances [where the contract clause would be modified to include the post-award examination of records clause] would involve a limited number of schedules." One of the arguments that industry made in 1999 to OFPP was the VA's inclusion of the clause in most of its schedules violated the "limited number of exceptions" language in the Final Rule. It was determined that VA's schedules represented a limited number of the total schedules; therefore, VA's decision to include the clause did not violate the Final Rule. However, if GSA now attempts to modify its solicitations to include the post-award access to records and right to examine records clause, without reinstating the clause that was deleted in 1997, the number of schedules that will be modified will likely exceed a reasonable interpretation of a "limited number" of schedules, which could impact on VA's schedules.

Reinstating the prior clauses will also eliminate the 2-year limitation on post-award audits of pricing information. Although the Final Rule provided VA authority to include the access to records and examination of records clause, it did not provide VA authority to amend the 2-year limitation imposed by the Final Rule. Based on the audits we have conducted since 1997 and other information, the 2-year restriction has limited VA's ability to recover some overcharges that were incurred by the Government outside the 2-year time period. Because the majority of our post-award work has been in response to voluntary disclosures, we have not been able to conduct self-initiated audits of awards and modifications within the 2-year time period. Reinstating the pre-1997 clause which allowed for post-award audit rights for pricing information in all FSS contracts would resolve the 2-year restriction.

The evaluations conducted by GAO of VA and GSA's FSS programs that were published in reports issued in June 2004, *Contract Management — Further Efforts Needed to Sustain VA's Progress in Purchasing Medical Supplies*, and February 2005, *Contract Management — Opportunities to Improve Pricing of GSA's Multiple Award Schedules Contracts*, show that post-award audits are clearly in the best interest of the Government.

In the June 2004 report, GAO stated:

> "VA's FSS and national contracts generally provide favorable prices and have achieved savings – in part, because VA has built into its contracts important clauses that allow it to aggressively pursue best prices for medical products and services. For example, through its FSS contracts, VA exercises audit rights and access to contractor data, which have helped VA negotiate better prices and achieve savings totaling $240 million from fiscal years 1999 to 2003."

Response to Concerns Raised by Industry

Throughout the past 10 years, industry has made a number of arguments in opposition to post-award audits of commercial sales practice information submitted during negotiation of the contract or contract modification. These arguments include that the audits are not a commercial practice, are overly broad, and are overly burdensome on the contractor. We do not believe these arguments have merit.

As the custodians of the public trust, we believe that the proper benchmark on the issue of conducting post-award audits is whether the audits are in the best interest of the Government, not whether they are a commercial practice. The reports issued by GAO that evaluated and compared the schedules managed by VA and GSA clearly show that the post-award audits are in the best interest of the Government. Conducting post-award audits of pricing information provided during negotiations is not a commercial practice; but, the manner in which FSS contracts are negotiated, awarded, and managed is not a commercial practice either. Therefore, it would be inequitable to apply a commercial practice standard to aspects of the program for which there is no commercial equivalent.

As VA and VA OIG noted in response to the Advance Notice, there are many benefits in Government contracting that do not exist in the commercial market; yet industry has not requested that these procedures be changed to reflect commercial practices. For example, the commercial market does not provide contractors with the opportunity to file a protest challenging the award process; in addition, the Competition in Contracting Act provides industry with broad opportunities to compete for Government business.

Industry has not provided any evidence to support the general complaint that the audits are overly broad. The time period covered by the audit and the information that can be reviewed are defined by the terms and conditions of the contract. We are not aware of any specific audit in which the Division acted outside the scope of the terms and

conditions of the contract. If such an event occurred and was reported, appropriate action would be taken.

Industry also has not provided evidence to support its complaint that the audits are overly burdensome, intrusive, and significantly disrupt business activities. Since 1993, the Division and the NAC have taken steps to streamline the pre-award and post-award audit process to make them more efficient and less burdensome on the vendors. For example, a key aspect of either audit is the review of the vendor's commercial sales transaction data, needed to verify the commercial sales practice information, provided in response to the solicitation or a request for modification. To streamline the process, vendors are asked to provide commercial sales transaction data in electronic format. This eliminates the need for the vendor to locate, audit, and copy volumes of hard copy invoices and other sales records. We have reviewed large and small businesses and found that most maintain records in electronic format, that the information is maintained for many purposes, not just Government audit requirements, and that the information is readily available for review. If additional information is needed, such as commercial contracts, policies, etc., the vendor is asked to provide copies either electronically or by mail. On-site audits at the vendor's place of business are only conducted on an as-needed basis and are usually completed in 2 days or less. To further streamline the process, when the solicitation for the pharmaceutical schedules were issued in 2002, VA included a provision that notified vendors that a pre-award audit would be done, identified specific information that would be needed for the audit, and required vendors to have the data available when they submitted their proposal.

PRE-AWARD AND POST-AWARD AUDITS IMPROVE CONTRACTING AND PURCHASING PRACTICES

Pre-award and post-award audits provide VA with valuable information regarding the commercial practices within the various industries and among the vendors who sell products under FSS contracts awarded by VA. This information has been used to develop pricing schedules and agreements that allow VA and other Government customers to take advantage of discounts and incentives offered commercial customers. The information obtained also provides VA within broad insight into VA purchasing practices and the impact they have on VA's ability to negotiate and maintain fair and reasonable prices.

Audits have shown that vendors often do not provide accurate, complete, and current CSP information. It is not uncommon for the audit to identify discounts or other incentives which result in lower net prices that were not disclosed. In many cases, vendors do not provide this information to VA because they maintain that the Government is not entitled to or eligible for these discounts. However, this is not consistent with GSA policy which requires full disclosure and allows the contracting officer to make the determination.

The following are examples of commercial sales practices that often have not been disclosed or were misrepresented during negotiations:

- Quantity Commitments: Commercial customers receive better net prices than FSS because they have committed to purchase specific quantities of the vendor's product. It was represented that FSS customers were not qualified to receive these lower prices because the FSS contract was an indefinite quantity contract. The audits found that there was no real distinction, because the value of the commitment was often far less than the Government purchased without a commitment. With one exception, the commitment goals were not monitored by the vendor and there was no penalty for non-compliance or penalties were not enforced.

- Market Share Commitments: Commercial customers commit to purchasing a percentage of their annual needs of a specific product or group of products from the vendor, whereas, the FSS contract does not. The audits found that the customer's annual needs were not quantified in the agreement. Without a basis to compare the amount purchased from the vendor versus the amount purchased overall, the commitment is unenforceable.

As a result of audit findings such as these, contracting officers are now more familiar with commercial sales practices and are able to ask pertinent questions or request specific information to determine whether there is a valid distinction and, if so, whether the Government can meet the requirements. As one example, a vendor offered the Government a 15 percent discount on its entire product line. The pre-award audit showed that 92 percent of commercial customers received discounts that ranged from 35 to 41 percent. The vendor argued that these discounts were offered only to customers that entered into single source agreements that required the customer to purchase these products only from that vendor; whereas, under the terms of the FSS, customers were not required to enter into similar agreements. The pre-award audit established that there were only two vendors who manufactured this product; it also found that medical facilities purchased one vendor's product or the other but not both. An audit of records maintained by the vendor showed that VA's purchasing patterns mirrored those of commercial customers. Based on these findings, it was determined that the vendor's distinction between Government and commercial customers was without merit. Once a medical facility selected one vendor's product over the other, the facility had, in fact, committed to buying that vendor's product. Based on the audit, VA was able to implement a tiered pricing structure and negotiate discounts for FSS customers that paralleled those offered to commercial customers. The estimated cost savings was $9 million.

Information obtained through pre-award and post-award audits has been used by VA to improve procurement practices in general.

- On December 23, 1992, the Division issued a report, *Review of VA's Negotiations on Selected High Dollar Value Federal Supply Schedule Pharmaceutical Contracts,* in which we identified systemic issues relating to the negotiation and award of FSS contracts. One finding was the identification and use of wholesaler

as the tracking customer for purposes of the Price Reductions Clause. This was found not in the best interests of the Government; since this category of customer did not receive discounts, the Government would not receive additional discounts or incentives offered to commercial customers during the term of the FSS contract. The report resulted in changes to the negotiation and award of FSS contracts, including the selection of a customer other than wholesalers as the tracking customer.

- In May 2001, the OIG issued a report to the VA Secretary, *Evaluation of the Department of Veterans Affairs Purchasing Practices*, which identified purchasing practices at VA medical centers that were negatively impacting the FSS program. In response to this report, the Secretary convened the Procurement Reform Task Force (PRTF) to develop a plan to implement changes to VA's procurement and purchasing practices. In May 2002, the Secretary approved the PRTF report and recommendations which made significant changes to VA's purchasing and contracting practices. For example, the OIG report stated that pre-award and post-award audits showed that vendors were opting not to have FSS or other contracts, or were not placing high-dollar/high-volume items on contract, because they were able to sell open market to VA medical centers at higher prices and without competition. One of the most significant outcomes of the PRTF was the identification of a mandatory purchasing hierarchy, which identifies FSS contracts as a mandatory source that must be used by VA purchasers before buying through a local contract or open market. As a result, vendors who previously decided not to have an FSS contract because it was more advantageous to sell open market submitted proposals for FSS contracts.

PROPOSAL TO TRANSFER 11 FSS SCHEDULES TO VA

We have submitted a proposal to VA and to the House Veterans Affairs Committee to transfer to VA the 11 schedules VA currently manages. For the past 45 years, VA has effectively and independently managed its FSS schedules. GSA does not contribute any resources to the solicitation, negotiation, award, or administration of any of VA's schedules; does not derive any financial benefit from sales under the schedules; and does not monitor VA's management of the schedules. In addition, the Government is represented by VA in protests and other administrative actions relating to the contracts and claims brought before the VA Board of Contract Appeals. Notwithstanding GSA's lack of involvement with VA's schedules, GSA retains the authority to promulgate and interpret regulations, and make decisions that affect these schedules – some of which have not been in the best interests of VA and other Government agencies that purchase products off VA's schedules. Through our audits, we have learned that there is a wide disparity in commercial practices among the various industries and among vendors within an industry. In addition to the cost savings and recoveries from pre-award and post-award audits, if the schedules are transferred from GSA to VA, VA would be able to use this information to promulgate regulations and develop contract clauses that are specifically tailored to the products and services on the VA schedules. We believe that this will result in contracts that better protect the interest of the Government.

CONCLUSION

Pre-award and post-award audits of FSS proposals and contracts are vital to ensuring that the Government negotiates and maintains fair and reasonable prices during the term of the contract. In addition to cost savings and recoveries, these audits help to ensure the integrity of the FSS program and provide the Government insight into commercial sales practices that can benefit the Government purchaser. While industry may not like the possibility of an audit, there is no objective data to support concerns that pre-award or post-award audits should be prohibited because the audits are unduly burdensome, intrusive, or otherwise disruptive of a vendor's business.

For the reasons stated above, we recommend that GSA modify the Examination of Records clause at GSAR 552.215-71 to reinstate the post-award access to records and right to examine records clause that was deleted by GSA's August 21, 1997, Final Rule. We also recommend that Congress consider transfer of the 11 schedules that VA currently manages from GSA to VA.

Thank you for the opportunity to testify. This concludes my formal statement. I will be pleased to answer any questions the Subcommittee may have.