

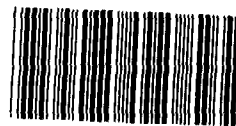
GAO

Fact Sheet for the Chairman,  
Committee on Governmental Affairs,  
U.S. Senate

March 1991

# CONTRACT PRICING

## Subcontractor Defective Pricing Audits



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National Security and  
International Affairs Division

B-242859

March 21, 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. In this report, we analyzed defective pricing audits performed by the Defense Contract Audit Agency (DCAA) to assess whether subcontractors complied with a key safeguard intended to ensure fair and reasonable prices on noncompetitive procurements—the Truth in Negotiations Act (P.L. 87-653, as amended). Our objectives were to determine (1) the frequency with which defective pricing<sup>1</sup> occurred in subcontracts and (2) the dollar impact of the defective pricing.

## Results in Brief

Despite the existence of the Truth in Negotiations Act, defective pricing in subcontracts is widespread and has caused contract prices to be significantly overstated. In fiscal years 1987-90, DCAA found defective pricing in 43 percent of the subcontracts audited. Defective pricing totaled more than \$880 million—an average of about \$1 million for each overpriced subcontract. Our analysis shows that defective pricing in subcontracts

- occurred slightly more frequently than defective pricing in prime contracts and at a higher dollar amount per contract;
- was greater at subcontract locations where DCAA had no permanent on-site office; and
- was found in all sizes of subcontracts, but the percentage of defective pricing was higher in small subcontracts.

## Background

In the past several decades, as the role of many prime contractors has changed from fabricating weapons and products to integrating work done by subcontractors, subcontract costs have become substantial. Active DOD subcontracts totaled \$195 billion at the end of fiscal year

<sup>1</sup>In the context of the Truth in Negotiations Act, subcontracts are considered to be defectively priced when subcontractor prices are higher than warranted due to subcontractors' failure to disclose accurate, complete, and current cost or pricing data.

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1989. As a result, the estimates included in contractor proposals for subcontracts are a critical element in establishing the reasonableness of contract prices. Because many weapons and related systems are complex, one-of-a-kind products, many DOD purchases come from one supplier and are therefore not subject to competitive marketplace forces. In the absence of marketplace forces, prices for noncompetitive contracts are generally determined through extensive negotiations.

Recognizing the government's vulnerability in noncompetitive contracting situations, the Congress passed the Truth in Negotiations Act in 1962 to place the government on an informational parity in negotiations with contractors. The act is intended to protect the government against inflated contract estimates. It requires contractors and subcontractors to submit cost or pricing data supporting their proposed prices above certain thresholds and to certify that the data submitted is accurate, complete, and current.

If contractors unknowingly provide inaccurate, incomplete, or noncurrent data that causes the contract price to be overstated, the act provides the government the right to reduce the contract price by the amount of the overpayment, plus interest. The act provides a more significant penalty for knowing submission of data that is not accurate, complete, or current—the contract price is reduced by the amount of the overpayment, plus interest, plus an additional amount equal to the overpayment.

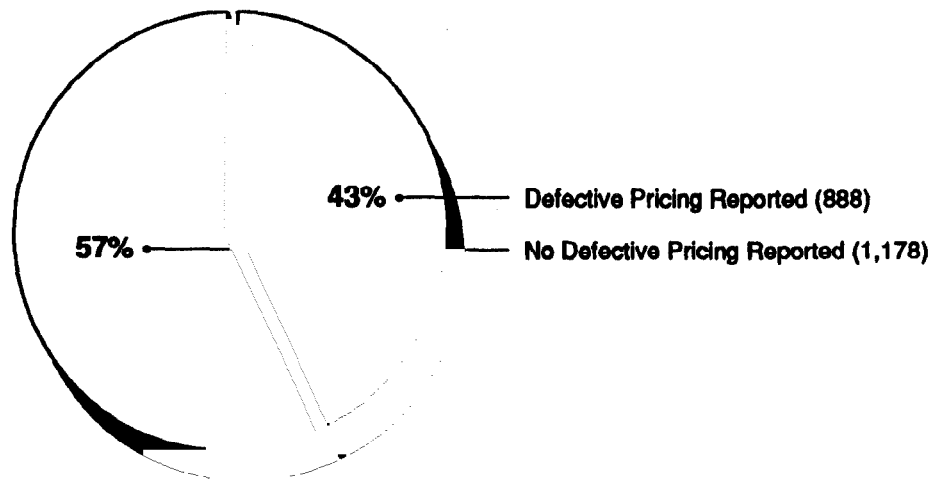
The fiscal year 1991 DOD Authorization Act (P.L. 101-510) mandated that the act's threshold be raised from \$100,000 to \$500,000, subject to a sunset provision returning the threshold to \$100,000 after December 31, 1995. The act requires DOD to prescribe regulations concerning the types of information to be submitted where cost or pricing data is required for contracts below the threshold.

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## Subcontract Defective Pricing Is Widespread and Costly

Subcontracts subject to the Truth in Negotiations Act are frequently overpriced. Of the 2,066 subcontract defective pricing audits DCAA completed between October 1, 1986, and September 30, 1990, 888 identified defective pricing.

**Figure 1: Frequency of Defective Pricing in Subcontract Audits Completed, Fiscal Years 1987-90**

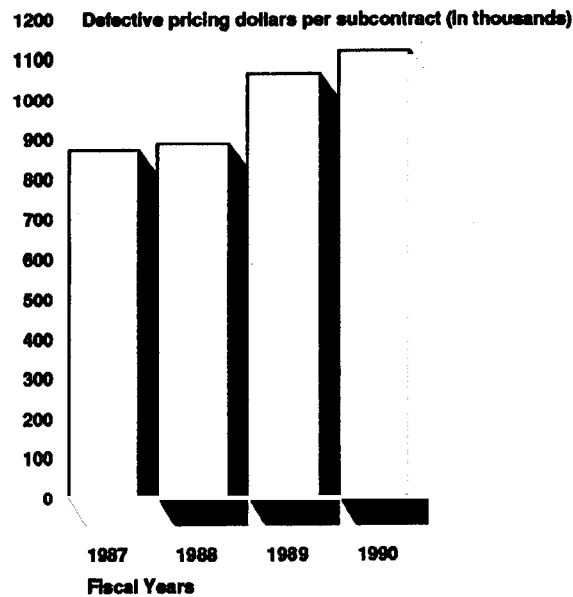


DCAA subcontract audits identified over \$880 million in defective pricing during the 4-year period—an average of nearly \$1 million for each over-priced subcontract. On average, the defective pricing made up about 1.6 percent of each subcontract's value. During the 4-year period, DOD recovered about 45 percent of the defective pricing reported by DCAA. In a separate report,<sup>2</sup> we identified several reasons why costs questioned in DCAA's defective pricing reports are not sustained.

Subcontract defective pricing reported by DCAA has been steadily increasing. In fiscal year 1990, DCAA reported subcontract defective pricing totaling \$264 million, an increase of \$83 million from the \$181 million DCAA reported in fiscal year 1987. In addition, as shown in figure 2, on a per subcontract basis, the amount of defective pricing has increased from about \$870,000 in fiscal year 1987 to over \$1.1 million in fiscal year 1990.

<sup>2</sup>Contract Pricing: Status of DOD Defective Pricing (GAO/NSIAD-91-33FS, Jan. 15, 1991).

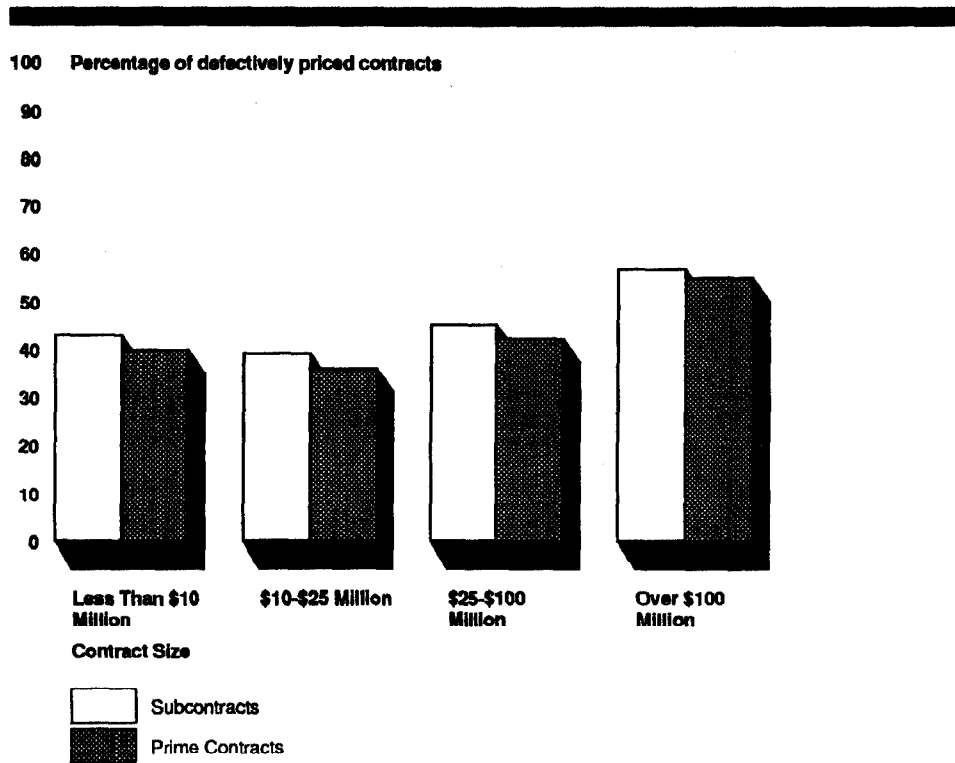
**Figure 2: Average Defective Pricing Per Subcontract Audited by DCAA**



## Frequency and Dollar Impact of Defective Pricing Among Subcontracts and Prime Contracts

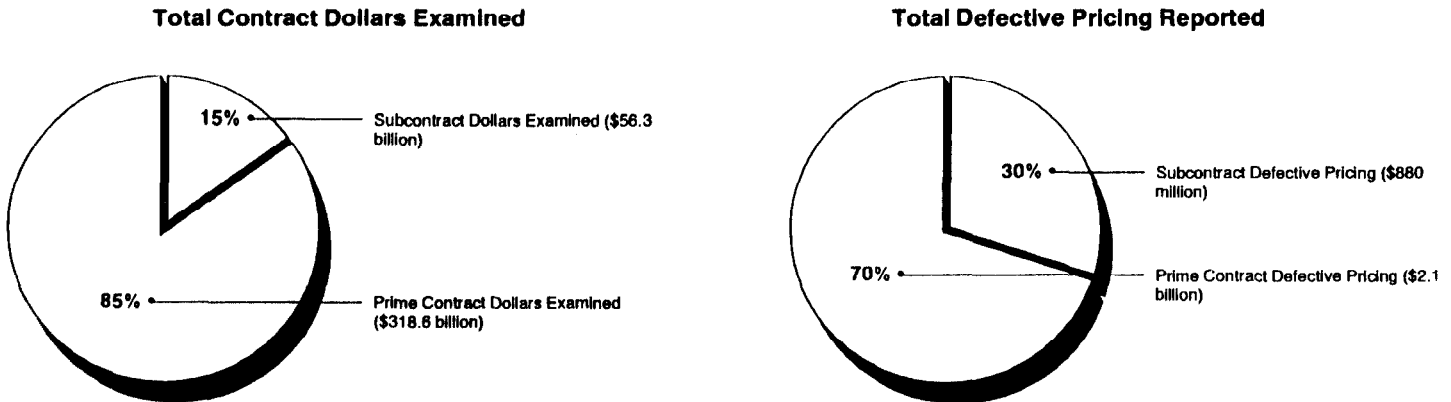
As shown in figure 3, defective pricing occurred slightly more frequently in subcontracts than it occurred in prime contracts regardless of contract size. During the period, DCAA identified defective pricing in 43 percent of the subcontracts audited, compared with 41 percent of prime contracts audited.

**Figure 3: Frequency of Defective Pricing in Contracts Audited by DCAA, Fiscal Years 1987-90, by Contract Size**



As figure 4 shows, while subcontracts accounted for 15 percent of all contract dollars DCAA audited (\$56 billion versus \$319 billion for prime contracts), subcontract defective pricing accounted for 30 percent of all defective pricing DCAA reported (\$880 million versus \$2.1 billion for prime contracts).

Figure 4: Total Contract Dollars Examined and Defective Pricing Reported, Fiscal Years 1987-90



On the basis of contract dollars examined, subcontracts contained more defective pricing per contract than prime contracts. Where defective pricing occurred, DCAA identified an average of \$991,000 of defective pricing per subcontract, compared to \$806,000 of defective pricing per prime contract, an average difference of about \$185,000 per contract.

### Most Subcontract Defective Pricing Is Identified by DCAA's Branch Offices

DCAA carries out its defective pricing audits through its headquarters, 6 regional offices, a field detachment in charge of classified work, and 156 field audit offices. DCAA headquarters develops policy and guidance. Regional offices and the field detachment provide planning and oversight. The field audit offices implement the defective pricing program.

In deciding which contracts to audit, DCAA classifies contractors as having the greatest risk of defectively priced contracts if they are known to have chronic estimating and accounting systems deficiencies or are being investigated for suspected fraud and unlawful activity. For such high-risk contractors, DCAA's fiscal year 1990 audit selection criteria called for audits of all fixed-priced contracts of \$10 million or more. The selection criteria also called for audits of 1 in 10 high-risk contracts between \$1 million and \$10 million, and only 1 of 50 high-risk contracts between \$100,000 and \$1 million. DCAA allocated all the resources needed to audit high-risk contracts over \$10 million. However, due to resource constraints, DCAA was able to allocate only 61 percent of the resources for audits of high-risk contracts under \$10 million.

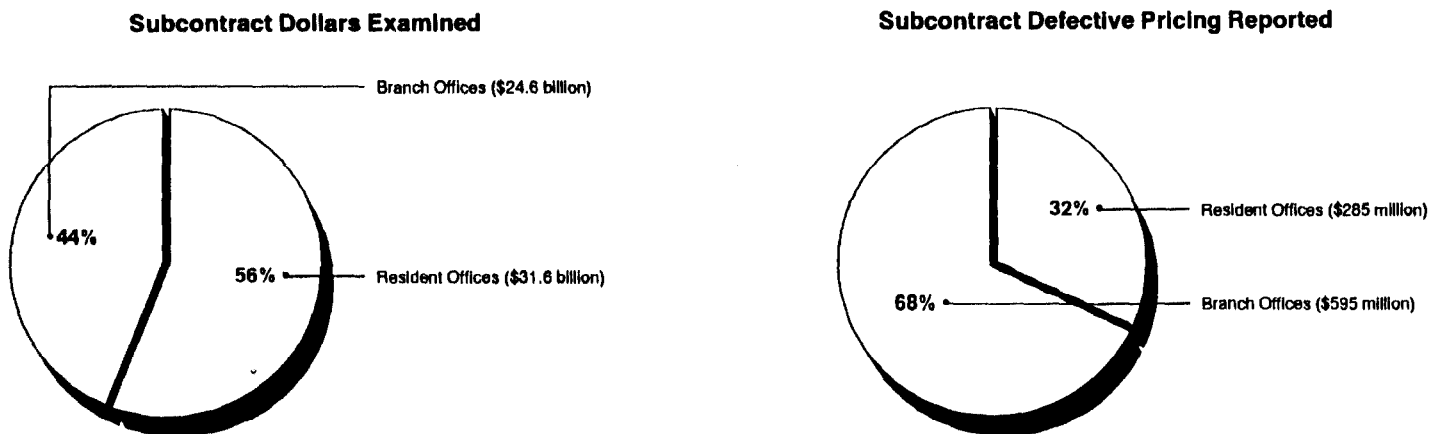


The portion of total DCAA field office staff resources devoted to defective pricing audits was about 10 percent in fiscal year 1990, compared with about 7 percent in fiscal year 1987. During the 4-year period, DCAA conducted 8,333 defective pricing audits. Of the total, 6,267 audits covered prime contracts and 2,066 covered subcontracts.

DCAA has two types of field audit offices: branch offices and resident offices. Generally, branch offices are responsible for several contractors in a designated geographical area, while resident offices are responsible for a single major contractor, and are physically located at the contractor's plant. Branch offices conducted about 70 percent of the subcontract audits completed for the 4-year period we examined. Defective pricing was found in 44 percent of the subcontract audits conducted by branch offices and 40 percent of the subcontract audits conducted by resident offices.

We analyzed subcontract audit results reported by branch offices and resident offices to determine whether subcontract defective pricing is more prevalent or less prevalent when a DCAA field office is on location. Although the frequency of defective pricing was slightly higher at branch offices, the dollar impact of subcontract defective pricing reported by branch offices was significantly greater. As figure 5 shows, branch office audits accounted for 44 percent of all subcontract dollars audited. However, branch offices identified 68 percent of the subcontract defective pricing.

Figure 5: Subcontract Dollars Examined and Defective Pricing Reported by Branch and Resident Offices, Fiscal Years 1987-90



## Defective Pricing in Smaller Subcontracts

Over half (53 percent) of the 2,066 subcontracts DCAA audited in fiscal years 1987 through 1990 were under \$10 million. The incidence of defective pricing in these relatively smaller subcontracts mirrored the overall incidence of defective pricing of 43 percent regardless of contract size.

However, these smaller subcontracts had, as a percentage of contract value, more defective pricing than did larger subcontracts. As table 1 shows, defective pricing was, on average, 11.8 percent of the total value of these subcontracts. By comparison, defective pricing in subcontracts valued at \$100 million or more averaged 1.5 percent of total subcontract value.

**Table 1: Average Defective Pricing as a Percentage of Subcontract Value Between Fiscal Years 1987-90**

Subcontract value	Percent of subcontract value
Over \$100 million	1.5
\$25 to \$100 million	4.0
\$10 to \$25 million	5.2
Under \$10 million	11.8

Furthermore, as shown in table 2, the percentage of defective pricing for subcontracts under \$10 million also increased as the size of the subcontract decreased, rising to 25.1 percent of subcontract value for subcontracts valued at \$500,000 or less.

**Table 2: Average Defective Pricing as a Percentage of Subcontract Value Between Fiscal Years 1987-90**

Subcontract value	Percent of subcontract value
\$5 to \$10 million	10.2
\$1 to \$5 million	13.1
\$500,000 to \$1 million	17.9
Under \$500,000	25.1

Over the 4-year period, DCAA audited 134 subcontracts under \$500,000 and found \$3.8 million of defective pricing on 55 of the subcontracts.

## Scope and Methodology

We reviewed DCAA defective pricing audits completed between October 1986 and September 1990. We relied on DCAA's automated information system, which contained information on completed audits. Since we used computer-processed data to support our audit objectives, we evaluated and selectively tested controls over the data. Our testing did not identify significant data accuracy problems, although we identified some minor

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internal control weaknesses, as well as a small number of input errors in DCAA's data base. Therefore, we believe the data is sufficiently usable for our audit efforts.

We reviewed DCAA policy and guidance on defective pricing audits. We also interviewed selected DCAA officials responsible for the defective pricing program at DCAA headquarters in Washington, D.C.; the Western regional office in San Francisco, California; and field audit offices located in Seattle, Washington; San Diego, California; and Stratford and Windsor Locks, Connecticut.

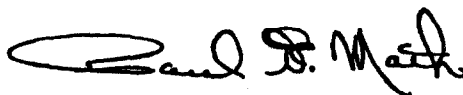
As arranged with your office, we did not obtain written agency comments. However, we discussed the report with agency officials and have included their comments where appropriate. These officials agreed with the facts presented in the report. We conducted our review between May 1990 and February 1991 in accordance with generally accepted government auditing standards.

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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, Office of Management and Budget; and 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. Other major contributors to this report are listed in appendix I.

Sincerely yours,



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

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# Major Contributors to This Report

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