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Report to the Secretary of Defense

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August 1994

# CONTRACTOR OVERHEAD COSTS

## Money Saving Reviews Are Not Being Done as Directed



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**United States  
General Accounting Office  
Washington, D.C. 20548**

**National Security and  
International Affairs Division**

**B-257582**

**August 3, 1994**

**The Honorable William J. Perry  
The Secretary of Defense**

**Dear Mr. Secretary:**

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In 1991 and 1992, our office and the Department of Defense (DOD) Inspector General, respectively, reported that overhead should-cost reviews had saved hundreds of millions of dollars and recommended that more emphasis be placed on such reviews. Should-cost reviews are a special form of cost analysis used to evaluate the economy and efficiency of a contractor's overhead operations.<sup>1</sup> In March 1992, the Director of Defense Procurement instructed contract administration activities to carry out more should-cost reviews. The purpose of this report is to advise you of the actions DOD has taken concerning these reviews.

**Results in Brief**

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Since being instructed in 1992 to conduct more should-cost reviews, DOD has done only four such reviews. Furthermore, all four of these reviews were initiated by the Air Force rather than the Defense Contract Management Command (DCMC), the organization primarily responsible for conducting the reviews. Since 1992, DCMC has acknowledged the importance of the reviews, but has not initiated any because, according to officials, of the time involved in developing regulations and an approach for performing those reviews. In June 1993, it asked its customers to identify potential candidates for should-cost reviews; they identified 17 candidates. DCMC plans to begin one should-cost review in July 1994 and another one after a contractor completes a restructuring action. DCMC did not consider the other 15 good candidates for should-cost reviews because of actions these contractors had taken to reduce overhead costs.

**Background**



In December 1984, DOD announced a program to improve its oversight of contractor overhead costs and to ultimately reduce these costs. The program responded to DOD's concern that inadequate management attention and surveillance of overhead costs may have allowed defense contractors to charge improper or excessive overhead costs to defense contracts. As part of its program, DOD emphasized the need to use

<sup>1</sup>Costs such as facilities and equipment, general office support, and supervisors' salaries are typically classified as overhead costs, or indirect costs, because they are not directly assignable to a specific contract but benefit more than one contract.

evaluation tools such as overhead should-cost reviews to help control costs.

The overhead should-cost review is a specialized form of cost analysis that differs from DOD's traditional evaluation methods. In traditional evaluations, local contract audit and administration personnel primarily base their evaluation of forecasted overhead costs on an examination of historical costs and trends. In contrast, overhead should-cost reviews do not assume that a contractor's historical costs reflect efficient and economical operations. Instead, they involve evaluating the economy and efficiency of a contractor's existing workforce, methods, materials, facilities, operating systems, and management. They also involve using an integrated team of DOD contracting, contract administration, pricing, audit, and engineering representatives. These representatives conduct a comprehensive evaluation of overhead costs to identify both short- and long-range initiatives needed to improve the economy and efficiency of a contractor's operations.

*Contractor overhead costs historically have comprised a large part of the total cost of defense contracts. As defense budgets decline and contractor business bases become smaller, overhead costs are likely to constitute an even larger part of future contract costs. Furthermore, DOD's move from fixed-price to cost-type contracts for development efforts will shift more of the overhead cost risk to the government.*

## Overhead Should-Cost Reviews Have Saved Hundreds of Millions of Dollars

On July 1, 1990, all of the services' contract administration organizations were consolidated into the newly created DCMC<sup>2</sup> within the Defense Logistics Agency. After the reorganization, DCMC performed some should-cost reviews but began to use more reviews of another type<sup>3</sup> to evaluate contractors' proposed overhead costs. In view of the significant decrease in the use of overhead should-cost reviews, we recommended in our 1991 report<sup>4</sup> that the Secretary of Defense (1) revise the procurement regulations to provide guidance on the use of these reviews and (2) place

<sup>2</sup>As a result of the consolidation, DCMC became responsible for conducting overhead should cost reviews at all contractor locations, except those under the auspice of the Supervisor of Shipbuilding, Conversion, and Repair.

<sup>3</sup>The other reviews, called "in-depth" reviews, also evaluate the economy and efficiency of a contractor's operations; however, they do not approach the depth of coverage or resources used in overhead should-cost reviews.

<sup>4</sup>Contract Pricing: Economy and Efficiency Audits Can Help Reduce Overhead Costs (GAO/NSIAD-92-16, Oct. 30, 1991).

more emphasis on measures to reduce contractor overhead costs, including use of overhead should-cost reviews.

Our 1991 report showed that DOD's overhead should-cost reviews had saved hundreds of millions of dollars. For example, the services and the Defense Logistics Agency estimated that five reviews completed in fiscal year 1985 had saved \$1.1 billion, compared with an estimated cost of \$2.4 million to conduct the reviews. Further, Air Force contracting officers reduced contractors' proposed overhead costs by \$2.4 billion as a result of four reviews conducted during fiscal years 1986 and 1987. According to the Air Force, the reductions were double those contracting officers had achieved in prior overhead negotiations using traditional evaluation techniques.

For our 1991 report, we examined the results of forward-pricing rate agreement<sup>5</sup> negotiations at selected contractor locations. At 12 contractor locations where overhead should-cost reviews were conducted, DOD negotiators reduced contractors' proposed overhead costs by \$3.8 billion, which was over a 10-percent reduction of the proposed amount, as a result of should-cost reviews. In February 1992, DOD's Inspector General issued a report<sup>6</sup> that confirmed our findings.

## DOD Directs That Overhead Should-Cost Reviews Be Done

In response to our report, the Director of Defense Procurement by memorandum dated March 31, 1992, submitted proposed regulations on the use of overhead should-cost reviews to the regulatory review process.<sup>7</sup> In a separate March 31, 1992, memorandum, the Director, realizing the benefits of the reviews, instructed contract administration activities to carry out overhead should-cost reviews at selected contractors.

On May 28, 1992, DCMC headquarters advised its district offices that the Office of the Secretary of Defense had drafted regulations on performing overhead should-cost reviews and had directed the reviews be done while the regulations were being processed. The proposed regulations were

<sup>5</sup>A forward-pricing rate agreement is a written agreement between a contractor and DOD to use certain overhead rates in the negotiation of contracts or contract modifications over a specified period of time. These agreements eliminate the need to negotiate separate overhead rates for each contract or contract modification at contractors where the volume of negotiated contracting is significant.

<sup>6</sup>Forward Pricing Rate Agreements (Report No. 92-055, Feb. 27, 1992).

<sup>7</sup>Revisions to the Federal Acquisition Regulation are prepared and issued through coordinated action of the Defense and Civilian Acquisition Regulatory Councils. After these Councils agree on a revision, it is then published in the Federal Register for public review and comment.

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published in the Federal Register for review and comment on April 6, 1994, over 2 years after they were submitted for review.<sup>8</sup>

Since the Director's 1992 memorandum, only four overhead should-cost reviews have been done. Furthermore, DCMC initiated none of these reviews. The Air Force initiated three of the reviews because it was concerned about overhead cost growth in the F-22 fighter aircraft program. The fourth review was done to facilitate production planning. These four reviews are projected to result in estimated savings ranging from \$271 million to \$340 million.

DCMC officials told us that several factors contributed to their initiating no reviews. The primary factor cited was that the draft regulations could not be issued because of the moratorium. DCMC officials said they therefore had to plan for such matters as contractor selection criteria, risk assessment details, and resources to do the reviews. They said these planning activities took a considerable amount of time to accomplish. While some planning was no doubt necessary, overhead cost reviews had been successfully accomplished in prior years without regulatory guidance and the Director of Defense Procurement had instructed that the reviews be done while the regulations were being finalized.

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## Plans to Accomplish Overhead Should-Cost Reviews

Subsequent to DOD's March 1992 instruction to accomplish overhead should-cost reviews, several DCMC customers, including the Army's Senior Acquisition Executive, advised DCMC headquarters of their concern about overhead cost growth and means to control and reduce these costs. Although DCMC officials have acknowledged the potential contribution of should-cost reviews, DCMC has been slow in initiating such reviews. The following illustrates how limited the progress has been.

- In November 1992, the Army's Senior Acquisition Executive identified should-cost reviews as one initiative planned to monitor the management of contractor overhead costs. However, DCMC did not make the should-cost reviews a part of its ongoing overhead assessment program.
- In April 1993, the Army Material Command (AMC) expressed the need to conduct overhead should-cost reviews at selected contractor sites. It called the March 1992 memorandum a "call to arms" to conduct the reviews and already knew which contractors would be good candidates. AMC stated it was ready to supply technical, cost and pricing, and

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<sup>8</sup>At the time the proposed revision was prepared, the administration had directed agencies to refrain from issuing any proposed or new regulations. The moratorium remained in effect until January 31, 1993. After the moratorium expired, a backlog of regulations had to be processed.

administrative talent for accomplishing the reviews and requested DCMC's active participation, but DCMC did not follow up.

- In May 1993, DCMC headquarters acknowledged it needed to develop a DCMC-wide approach for analyzing, evaluating, assessing, and negotiating contractor overhead costs. As part of the agencywide approach, DCMC requested that its customers—the services and the National Aeronautics and Space Administration—identify candidates for should-cost reviews. The customers recommended a total of 17 candidates for fiscal year 1994.
- In January 1994, DCMC asked its district offices to determine which of the 17 reviews to perform first. In June 1994, DCMC headquarters determined that reviews should be done at only 2 of the 17 candidates. One of these reviews is scheduled to begin in July 1994, and the other is being delayed until the company completes its restructuring action. The other 15 candidates were eliminated because they were considered low risk or, in one case, the company was not under DCMC's jurisdiction. In assessing risk, DCMC looked at the stability of the contractors' business bases; actions taken to reduce overhead costs; whether the contractors had formal plans to reduce overhead costs as their business bases fell; and other factors. The major customers of these contractors concurred with DCMC's low risk assessment.
- In June 1994, DCMC headquarters directed its district offices to conduct a risk assessment of 78 contractors designated as cost monitoring sites<sup>9</sup> to determine the future need for should-cost reviews.

## Recommendation

Because DCMC has not responded to the March 1992 instruction on performing overhead should cost reviews, we recommend that the Secretary of Defense re-emphasize the instruction and establish appropriate mechanisms for ensuring that it is carried out in a timely manner.

## Scope and Methodology

We reviewed various records at DCMC, including information showing the number of overhead should-cost reviews carried out since the March 31, 1992, memorandum on these reviews. We also examined DCMC records showing future plans for overhead should-cost reviews and the milestones for accomplishing these reviews. In addition, we visited officials in the Office of Assistant Secretary of the Navy, Office of Assistant Secretary of the Air Force, and AMC and discussed various aspects of overhead should-cost reviews. We did not obtain written agency comments on this

<sup>9</sup>DCMC selects contractors as cost monitoring sites based on the expected sales to the government during the next fiscal year, the government's share of indirect costs for these sales, and other criteria.

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report. However, we discussed our draft report with officials from the Office of the Secretary of Defense, the services, the Defense Logistics Agency, DCMC, the Defense Contract Audit Agency, and the Office of the DOD Inspector General and have included their comments where appropriate. We conducted our review from July 1993 to June 1994 in accordance with generally accepted government auditing standards.

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As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement of the actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report. A written statement must also be submitted to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Defense Logistics Agency; Commander, DCMC; the Secretaries of the Air Force, the Army, and the Navy; and interested congressional committees. We will make copies available to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix I.

Sincerely yours,



David E. Cooper  
Director, Acquisition Policy, Technology,  
and Competitiveness Issues



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# Major Contributors to This Report

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