Audit Report

OFFICE OF THE INSPECTOR GENERAL

FINAL AUDIT REPORT ON
UNDEFINITIZED CONTRACTUAL ACTIONS

Report Number 92-048

February 14, 1992

Department of Defense

The following acronyms are used in this report.

AFAA.....Air Force Audit Agency
ASO.....Aviation Supply Office
DFARS .....Defense Federal Acquisition Regulation Supplement
DLA .....Defense Logistics Agency
GAO .....General Accounting Office
MICOM.....Missile Command, U.S. Army
NAVSEA.....Naval Sea Systems Command
SPCC .....Ships Parts Control Center, U.S. Navy
SUPSHIP .....Supervisor of Shipbuilding, Conversion and Repair
TACOM .....Tank-Automotive Command, U.S. Army
UCA .....Undefinitized Contractual Actions

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

February 14, 1992

MEMORANDUM FOR DIRECTOR OF DEFENSE PROCUREMENT
COMPTROLLER OF THE DEPARTMENT OF DEFENSE
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Undefinitized Contractual Actions (Report No. 92-048)

We are providing this final report for your information and use. This audit was Congressionally mandated under section 908 of Public Law 99-661 (United States Code, title 10, section 2326), which required the Inspector General, DoD, to perform periodic audits on the management of undefinitized contractual actions under the control of the Secretary of Defense. Management comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Therefore, we request that the Director of Defense Procurement, the Assistant Secretary of the Army, the Assistant Secretary of the Navy, and the Director of the Defense Logistics Agency provide final comments on the unresolved recommendations and potential benefits by April 15, 1992. See the "Response Requirements Per Recommendation" section at the end of the finding for the unresolved recommendations and the specific requirements for your comments. DoD Directive 7650.3 also requires that comments indicate concurrence or nonconcurrence in the finding and each recommendation addressed to you. If you concur, describe the corrective actions taken or planned, the completion dates for actions already taken, and the estimated dates for completion of planned actions. If you nonconcur, state your specific reasons for each nonconcurrence. If appropriate, you may propose alternative methods for accomplishing desired improvements.

The report recommendations should produce monetary benefits and savings as a result of more effective management of undefinitized contractual actions, through reduced risk of contract overpricing, and more complete control of undefinitized contractual actions. However, these monetary benefits are not quantifiable at this time. We would appreciate any comments you might provide on your estimate of potential monetary benefits. Recommendations are subject to resolution in accordance with DoD Directive 7650.3 in the event of nonconcurrence or failure to comment.

We appreciate the cooperation and courtesies extended to the audit staff. If you have any questions on this final report, please contact Mr. Richard Jolliffe, Program Director, at (703) 614-6260 (DSN 224-6260), or Mr. Timothy Staehling, Project Manager, at (703) 614-6248 (DSN 224-6248). Copies of the final report will be distributed to the activities listed in Appendix I.

Edward R. Jones
Deputy Assistant Inspector General
for Auditing

cc:
Secretary of the Army
Secretary of the Navy
Under Secretary of Defense for Acquisition
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Director, Defense Acquisition Regulations Council
Director, Defense Finance and Accounting Service

Office of the Inspector General, DoD

AUDIT REPORT NO. 92-048 February 14, 1992
(Project No. 0CA-0051)

FINAL AUDIT REPORT ON UNDEFINITIZED CONTRACTUAL ACTIONS

EXECUTIVE SUMMARY

Introduction. The total reported value of DoD FY 1988 and FY 1989 undefinitized contractual actions amounted to $10.4 billion. Public Law 99-661 (United States Code, title 10, section 2326) and the Defense acquisition regulations require that undefinitized contractual actions be properly awarded, correctly obligated, and definitized in a timely manner.

Objectives. The objective of this audit was to evaluate the DoD implementation of section 908 of Public Law 99-661, "National Defense Authorization Act for FY 1987." The audit evaluated whether:

- undefinitized contractual actions were being properly managed, and

- internal controls over undefinitized contractual actions were adequate.

Audit Results. DoD had reduced not only the number of undefinitized contractual actions, but also the dollar value of $22.1 billion reported during the mid-1980s. Despite the large reduction in undefinitized contractual actions, DoD contracting officers did not properly manage undefinitized contractual actions or adequately control change order modifications. These conditions resulted in increased cost risks unnecessarily incurred by DoD in the award, obligation, and negotiation of undefinitized contractual actions. Our review of $2.8 billion of undefinitized contractual actions disclosed an estimated $40.8 million of profits that exceeded the contractors' justifiable risk on the portion of those contracts on which costs were incurred. The Air Force was not included in our audit because of recent Air Force Audit Agency reviews, which also found that undefinitized contractual actions were not being properly managed in the Air Force Logistics and Systems Commands.

Internal Controls. The audit found material internal control weaknesses in the award, obligation, and negotiation of undefinitized contractual actions. See the finding for details of these weaknesses and page 4 for details of our review of internal controls

Potential Benefits of Audit. The report recommendations should produce monetary benefits through effective DoD management of undefinitized contractual actions, through reduced risks of contract overpricing of profits, and through complete control of undefinitized contractual actions as a result of improved internal controls. However, we could not quantify these potential monetary benefits and savings, which are summarized in Appendix F.

Summary of Recommendations. We recommended that guidance be issued to establish procedures that ensure compliance with the Defense regulations, that adequate internal controls be established, and that Defense Federal Acquisition Regulation Supplement 217.7404-4, "Limitation on Expenditures," be revised to reflect the statutory requirements of United States Code, title 10, section 2326.

Management Comments. The Assistant Secretary of the Army (Research, Development and Acquisition) concurred, the Assistant Secretary of the Navy (Research, Development and Acquisition) partially concurred, and the Deputy Comptroller of the Defense Logistics Agency nonconcurred with the recommendations on issuing guidance and establishing written internal control objectives and techniques for undefinitized contractual actions. The Deputy Comptroller of DoD fully concurred with the recommendation to establish specific internal controls at DoD finance offices. Management comments are synopsized in Part II of the report. Although no response was requested, the Director of Defense Procurement provided comments on our audit finding. A synopsis of the Director's comments and our audit responses are at Appendix H. The complete text of management comments is provided in Part IV of the report.

We request that the Navy and the Defense Logistics Agency reconsider their positions, and provide additional comments on Recommendation 1., on issuing guidance and establishing written internal control objectives and techniques. Also, we request that the Army provide estimated completion dates for the actions planned on Recommendation 1., and that the Director of Defense Procurement provide comments to Recommendation 3., which was added to the final report. Additional comments are requested by April 15, 1992.

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This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD. Copies of the report can be obtained from the Information Officer, Audit Planning and Technical Support Directorate, (703) 693-0340 (DSN 223-0340).

PART I - INTRODUCTION

Background

An undefinitized contractual action (UCA) represents a contract action for which contract terms, specifications, or prices are not agreed on before performance begins. UCAs include the following:

- letter contracts (authorizes contractors to begin work immediately),
- unpriced orders placed under basic ordering agreements,
- unpriced provisioned item orders (initial spare parts), and
- unpriced contract modifications (changes to existing contracts).

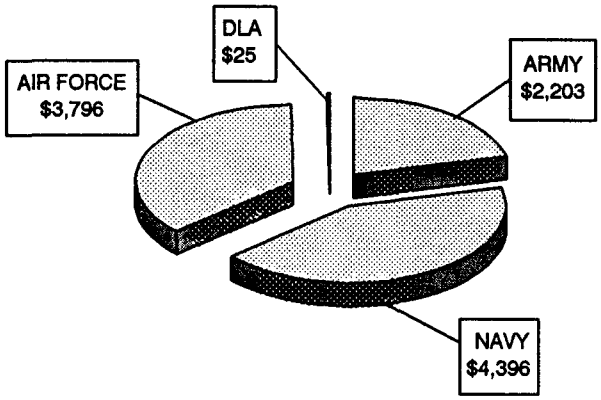
Under section 908 of Public Law 99-661, "National Defense Authorization Act for FY 1987," (United States Code, title 10, section 2326) (see Appendix E) UCAs do not include:

- foreign military sales,
- purchases of less than $25,000,
- special access programs, and
- congressionally mandated long-lead procurement contracts.

UCAs should be approved at a level above the contracting officer, consistent with the total estimated dollar value of the action.

The total reported dollar value of the Military Departments and Defense Logistics Agency (DLA) UCAs for FY 1988 and FY 1989 amounted to $10.4 billion.

FY 1988 And FY 1989 UCA REPORTED AMOUNTS
(in millions)



Defense Federal Acquisition Regulation Supplement (DFARS) Subpart 217.75 (renumbered as Subpart 217.74), "Undefinitized Contract Actions," requires that UCAs be properly awarded, correctly obligated, definitized in a timely manner, and include an appropriate negotiated profit amount based on incurred costs. The DFARS applies to UCAs entered into on or after April 16, 1987, and to all solicitations and contracts issued after April 16, 1987, contemplating their use.

Objectives

The objectives of this audit were to evaluate the DoD implementation of section 908 of Public Law 99-661, determine whether UCAs were being properly managed, and determine whether internal controls established for the definitization of UCAs were adequate.

Scope

Locations and contracts reviewed. The originally planned statistical sample of FY 1988 and FY 1989 UCAs (number and dollars) could not be used since the Military Departments and DLA could not completely support the reported amounts in the universe. In lieu of using a statistical sample, we judgmentally selected a random sample of UCAs at 19 Army, Navy, and DLA procurement contracting activities. The Air Force was excluded because the Air Force Audit Agency (AFAA) had reviewed UCAs at the Air Force Logistics and Systems Commands (See Prior Audits and Other Reviews section). We reviewed 173 contractual actions with a total UCA definitized price amount of $2.6 billion at the 19 audit locations as detailed in Appendix A of this report. We reviewed UCAs for:

- justification (authority),
- correct obligation of ceiling price amounts,
- timely definitization,
- documentation of incurred costs in definitization memorandums and assignment of profit rates reflecting reduced contractor risk, and
- overall adequacy of internal controls related to the definitization process.

Audit period and standards. This economy and efficiency audit was made from June 1990 through May 1991 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as were

considered necessary. The activities visited or contacted during the audit are listed in Appendix G.

The computer processed UCA summary statistics for the Military Departments and DLA were unreliable because they were not current, accurate, or complete. However, the reliability of computer processed UCA listings at the selected contracting activities was generally considered adequate to select individual UCAs for review. The reliability was confirmed by selectively verifying information on the listings to the detailed contract files. Because of the inaccuracies in the UCA summary statistics, we cannot state with any certainty that the $10.4 billion reported for FY 1988 and FY 1989 is correct.

Internal Controls

Controls assessed. We evaluated internal controls covering the award, obligation, and definitization of UCAs. Specifically, we reviewed the Army, Navy, and DLA policies and procedures for:

- adequate justification for awards,
- proper obligation of ceiling contract amounts,
- timely definitization, and
- proper awarding of definitized profit rates.

We also determined whether UCAs were measured as separate assessable units at each of the reviewed buying activities. Finally, we evaluated techniques used by the buying activities to ensure that UCA internal control objectives were accomplished.

Internal control weaknesses. The audit identified internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Controls were not established or effective to ensure that UCAs were properly managed in accordance with Public Law 99-661 and DFARS Subpart 217.75. Though the audit showed that UCAs were not measured as separate assessable units, certain buying activities did utilize internal techniques to monitor UCAs. Recommendations 1.c. and 2., if implemented, will correct the weaknesses. We could not determine the monetary benefits to be realized by implementing these recommendations because it was not possible to accurately project future benefits based on our sample review of FY 1988 and FY 1989 UCAs. Copies of the final report will be provided to the senior officials responsible for internal controls within OSD, the Army, the Navy, and DLA.

Prior Audits and Other Reviews

General Accounting Office (GAO) Report No. 86-59, (OSD Case No. 6891), "The Use of Unpriced Options and Other Practices Needs Revision," April 23, 1986, concluded that contracting officers were exercising unpriced options without proper written justifications. GAO recommended that contracts containing unpriced options be supported by written justifications before the options are exercised. DoD fully concurred with the recommendation and agreed to issue a general policy statement to the Military Departments and Defense agencies to that effect.

GAO Report No. 86-128, (OSD Case No. 7016), "Obligations Exceed Definitized Prices on Unpriced Contracts," May 2, 1986, found that DoD had funded UCAs at ceiling prices causing $136 million of excessive obligations. GAO recommended reviewing existing UCAs and deobligating excess funds while implementing DoD-wide controls. DoD concurred in the finding and recommendation and agreed to issue correcting policy guidance and initiate programs to address more timely definitizations.

GAO Report No. 87-91, (OSD Case No. 7016-A), "DoD's Use of Unpriced Contracts," April 30, 1987, presented the value of unpriced contracts at September 30, 1986, and discussed actions to control unpriced contracts. The report made no recommendations.

Naval Audit Service Report No. 040-N-89, "Undefinitized Contractual Actions in Selected Naval Sea Systems Command (NAVSEA) Programs," March 22, 1989, commented that the dollar value of Navy backlog was down 50 percent from FY 1985, but that the number of overage UCAs had increased as of September 30, 1987. The report also noted excessive obligations, untimely definitizations, and excessive profits being paid by NAVSEA. The Chief of Naval Operations generally agreed with the report findings and recommendations. Corrective actions included guidance on the use of UCAs and profit rates for complete or nearly complete UCAs; review of the UCA backlog to determine the reasons for untimely UCAs; and review of existing UCAs for the purpose of deobligating excess funds.

Air Force Audit Agency Project Number 9046413, "Management of Undefinitized Contractual Actions in Air Force Logistics Command," May 29, 1990, and Project Number 9046410, "Management of Undefinitized Contractual Actions in Air Force Systems Command," June 28, 1990, found inadequate justifications, untimely definitization, excessive obligations, excessive profits, and inaccurate reporting. Recommendations included revising Air Force UCA reporting requirements, providing contractors with positive or negative financial incentives for timely proposal submission, requiring contracting personnel to

obtain and consider incurred costs in determining profit objectives, and limiting obligations to not more than 50 percent of the contractor's estimated price. The Air Force Logistics and Systems Commands generally concurred with the findings and recommendations (see Appendix B for AFAA Executive Summaries related to both audits).

Inspector General, DoD, Report No. 86-085, "Negotiated Single-Source Procurements Using Unpriced Contractual Actions," April 1, 1986, showed untimely definitization of unpriced actions, Government liability being established at more than 50 percent of the not-to-exceed price, and no evidence in the price negotiation memorandums that costs incurred prior to definitization were used as a basis for negotiating profit. The Military Departments generally concurred in the findings and recommendations.

Other Matters of Interest

During the audit, a proposed change to DFARS Subpart 217.75 was issued for public comment. The final rule for this change was published in the Federal Register on July 31, 1991, with an effective date of December 31, 1991. The final rule (renumbered as Subpart 217.74) contained revised language in certain sections. First, DFARS 217.7404-1, "Authorization," states that "The request for approval must fully explain the need to begin performance before definitization, including the adverse impact on agency requirements resulting from delays in beginning performance." Second, DFARS 217.7404-3, "Definitization Schedule," states that "If the contractor does not submit a timely qualifying proposal; the contracting officer may suspend or reduce progress payments under FAR 32.503-6, or take other appropriate action." In addition, DFARS 217.7404-4, "Limitation on Expenditures," states "...if a contractor submits a qualifying proposal before 50 percent of the not-to-exceed price has been expended by the Government, then the limitation on obligations before definitization may be increased to no more than 75 percent...." These changes together with our Recommendation 3. in Part II of this report should improve UCA management.

PART II - FINDING AND RECOMMENDATIONS

DoD MANAGEMENT OF UNDEFINITIZED CONTRACTUAL ACTIONS

DoD contracting officers did not properly manage $2.8 billion of UCAs in accordance with U.S.C., title 10, sec. 2326 and DFARS Subpart 217.75 (renumbered as Subpart 217.74). This condition existed because DoD contracting officers did not fully comply with Defense acquisition regulations covering UCA awards, obligations, and negotiations. There also was an absence of adequate internal controls over UCAs. As a result, DoD has assumed increased cost risk in the award, obligation, and negotiation process. We concluded that for the reviewed unpriced contractual actions, DoD buying activities awarded profits of $40.8 million that exceeded the contractors' justifiable risk.

DISCUSSION OF DETAILS

Background

During the mid-1980's, there was congressional interest concerning the extensive reliance of DoD on UCAs. Congressional hearings stated that the high number of UCA awards resulted in transferring cost risk from the contractors to the Government. The Government was also placed at a distinctive disadvantage in negotiating final prices, since the contractor had already been awarded, and had started work on, the contract. To remedy this acquisition disadvantage, Congress, as part of Public Law 99-661, legislated section 908 of the Defense Acquisition Improvement Act of 1986, which was signed into law on November 14, 1986. This law set forth specific requirements related to the award, obligation, and negotiation of UCAs. The law included a requirement that the Inspector General, DoD, periodically conduct an audit of the management of UCAs within DoD. U.S.C., title 10, sec. 2326 incorporated section 908 restrictions on UCAs that in turn were implemented by DFARS Subpart 217.75. Section 908 also required the Secretary of Defense, with respect to the Defense Logistics Agency, and the Secretary of each Military Department to determine funds obligated (total and for UCAs) and undefinitized by 6-month periods, beginning on October 1, 1986, and ending on March 31, 1989.

Management of UCAs

The audit of 173 UCAs valued at $2.8 billion at 19 DoD buying activities (Appendix A) showed that DoD contracting officers were ineffective in ensuring: that UCAs were used appropriately, that statutory obligation limits were not exceeded, that definitizion was timely, and that contractors' incurred costs were considered during negotiations (see Appendix C for an example of a UCA).

Appropriate UCA justification authority. DFARS 217.7503, "Policy," states that the use of UCAs should be limited to the maximum extent practicable. Contracting officers should not enter into UCAs without prior authorization from the head of the agency or a designee. This section further requires that the authorization or justification for a UCA include a narrative statement of the specific operational impact on agency mission requirements if the UCA is disapproved. In the event of disapproval, contracting personnel must negotiate a definitively-priced contract before the contractor can begin work.

Detailed narrative statements of impact required to justify the UCAs were either lacking or inadequate for 65 (38 percent) of 173 contractual actions reviewed. The 65 contractual actions represented $313 million (11 percent) of the total reviewed not-to-exceed ceiling price amount of $2.8 billion. In 36 (55 percent) of the 65 instances the contract files did not contain any justification to issue the UCAs (32 of the 36 were Navy contracts). For example, our review of UCAs administered by the Defense Plant Representative Office at McDonnell Douglas, St. Louis, Missouri, showed that 9 of the 10 contracts reviewed did not contain a justification to issue the UCAs. For the remaining 29 of the 65 UCAs, the justifications in the contract files were not properly supported.

A typical example of a contract being issued without proper justifications included Contract N00024-88-G-2060, Order L8-03, awarded as a UCA by the Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP), Groton, Connecticut, on September 29, 1988, to obligate expiring funds before the end of the fiscal year. Disapproval of this UCA would not have impacted mission requirements since the item was procured based on the availability of funding rather than urgency. The Navy Ships Parts Control Center (SPCC) awarded six UCAs totaling $5,736,052 to obligate year-end funds. The award dates cited ranged from September 23 to September 30, 1988.

UCAs were issued without appropriate justification because Navy procurement personnel used a checklist form that required only a simple "check mark" answer to indicate whether disapproving the UCA would adversely impact the mission requirements. Further, procurement personnel did not provide adequate documentation in the contract files, and the narrative statement did not clearly justify the impact if the UCA was not issued before contractor performance began. There also was an absence of adequate internal controls. This issue will be discussed in greater detail under the internal controls section of this finding.

The heads of contracting activities, or their designees, authorized UCAs without the required determination of impact. We believe that improper approval and use of UCAs result in increased cost risk for the Government. In effect, awarding a

UCA without adequate authorization or justification, whether immediately or over a period of time, converts a fixed-price contractual instrument into a cost-type situation under which the contractor's cost risk is significantly reduced.

Limitations on obligation and expenditure of UCA funds. The DFARS sets forth the limitations on UCA funds obligations and expenditures. The final rule change to DFARS 217.7503(b)(4), "Limitation on Expenditures," which became effective December 31, 1991, more clearly states the intent of Congress. However, the change still does not express the plain language of the statutory requirements of U.S.C., title 10, sec 2326(b), "Limitations on Obligation and Expenditure of Funds." The final rule (renumbered as DFARS 217.7404-4) prescribes that:

> The Government shall not expend more than 50 percent of the not-to-exceed price before definitization. However, if a contractor submits a qualifying proposal before 50 percent of the not-to-exceed price has been expended by the Government, then the limitation on obligations before definitization may be increased to no more than 75 percent....

Of the 173 contractual actions reviewed, 105 (61 percent) exceeded the statutory obligation limits by a total of $210 million (Appendix A). In 82 (78 percent) of the 105 actions, 100 percent of the not-to-exceed ceiling price was incorrectly obligated. In addition, the funds obligated in 52 (50 percent) of the 105 actions exceeded the final definitized price by $56.0 million. This $56.0 million had been over obligated for an average of 444 days.

A typical contract action was Contract DAAE07-86-C-J111, Modification P00046, awarded by the U.S. Army Tank-Automotive Command (TACOM) as a UCA on September 23, 1988. TACOM initially obligated 100 percent of the not-to-exceed ceiling price of $4,548,139, instead of the statutory limit of 50 percent ($2,274,070). The UCA was definitized on May 25, 1990, for $3,372,777 resulting in $1,175,362 that needed to be deobligated ($4,548,139 less $3,372,777). As a result of the initial over-obligation, the $1,175,362 in excess of the final price was obligated for 609 days.

Another example of over-obligation was Contract N00383-88-G-B380, Order 0039, which the Naval Aviation Supply Office (ASO) awarded as a UCA on May 20, 1988. The Defense Plant Representative Office located at Pratt and Whitney, West Palm Beach, Florida, administered and negotiated this UCA. The contract's not-to-exceed price of $6,352,500 was also incorrectly obligated at 100 percent, instead of the 50 percent statutory limitation.

This UCA was subsequently definitized on June 25, 1990, for $4,197,380 resulting in a deobligated amount of $2,155,120 ($6,352,500 less $4,197,380). The $2,155,120 in excess of the definitized price was obligated for a period of 766 days.

The over-obligations of funds were caused by DoD contracting officers not fully complying with U.S.C., title 10, sec. 2326, limiting the initial obligation or expenditure of funds on UCAs to either 50 or 75 percent of the not-to-exceed contract ceiling price. This over-obligation was also caused by the DFARS reference to limitations on expenditures instead of the correct reference to limitations on obligation and expenditure of funds as stated in the law. As noted above, the revised final rule partially addresses the limitations on obligations. In addition, over-obligations resulted from the absence of adequate internal controls to ensure that contracting officers did not exceed statutory obligation or expenditure limitations for UCAs. Further, controls were inadequate at the DoD finance office level. This resulted in the over-obligation of UCA amounts in excess of statutory limitations.

The over-obligation of funds weakens the Government's negotiation position during the definitization process of the contract. The contractor has no motivation or incentive to work for timely definitization of the contract. Also, over-obligation limits availability of funds for use on other contracts and programs.

Timely definitization of UCAs. DFARS 217.7503(b)(3) requires that UCAs be definitized within 180 days or before funds expended under the UCA equal or exceed 50 percent of the not-to-exceed price. The 180-day period may be extended, but it may not exceed 180 days from the date the contractor submits a qualifying proposal.

Untimely definitization occurred in 115 (67 percent) of 171 contractual actions reviewed (see Appendix A). We could not use 2 of the 173 total UCAs reviewed in computing timely/untimely definitization. The average definitization time for the 171 UCAs was 295 days versus the 180-day period required by the law and regulations. Even when a contractor's qualifying proposal was submitted well in advance, or shortly after a UCA award, an untimely definitization still resulted. Definitization periods ranged from 4 days to more than 3 years. For example, on December 1, 1987, Contract N00019-85-G-0375, Order KK23, was awarded, but had not been definitized as of March 1, 1991, (our audit "cut-off" date). The Government had not received a qualifying proposal although this UCA had been undefinitized for 1,186 days, or over 3 years. Contract N00019-85-C-0477, Modification A00003, was also awarded as a UCA by the Naval Air Systems Command on March 2, 1988, (qualifying proposal dated August 18, 1988). As of March 1, 1991, this UCA still had not been definitized. Based on the contractor's qualifying proposal

date, 925 days had elapsed through our audit cut-off date of March 1, 1991. In several instances, for UCAs awarded prior to issuance of Public Law 99-661, effective April 16, 1987, definitizations ranged from 1,000 days to 1,806 days. For example, on May 30, 1985, Contract N00024-81-C-2118, Modification A00039, was awarded as a UCA by the Supervisor of Shipbuilding, New Orleans, Louisiana, but was not definitized until May 10, 1990, 1,806 days, almost 5 years, later.

Contracting officers were not using positive or negative incentives to obtain timely submission of contractor's proposals. For example, there was no evidence that monetary goals were employed as a positive means to accelerate the UCA negotiation process. In addition, the audit showed no evidence that DoD contracting officers used their legal contracting authority to reduce or suspend contractor progress payments in instances where timely submission of proposals was not evident. Finally, there was an absence of adequate internal controls to ensure that management information reports indicated the current status of UCAs and provided pertinent explanations as to why UCAs were not definitized in a timely manner in compliance with U.S.C., title 10, sec. 2326, and the DFARS.

The Government negotiating position was eroded by the transfer of cost risk from the contractor to the Government as a result of untimely definitization of UCAs. In effect, untimely definitizations resulted in a situation where the contractor had no real incentive to control costs or to sincerely negotiate with the Government. In addition, late definitizations resulted in a delay in recognizing and deobligating amounts that exceeded the final definitized price.

Consideration of incurred costs. DFARS 217.7503(b)(8), "Allowable Profit," requires that the head of an agency, or a designee, ensure that the profit negotiated on a UCA reflect any reduced cost risk of the contractor for costs incurred before the final price is negotiated. This section of the DFARS applies when the final price is negotiated after a substantial portion of the service is completed. The negotiated profit shall also reflect the reduced cost risks of the contractor for costs to be incurred during the remaining portion of the contract. In addition, DFARS Subpart 215.9, "Profit," provides guidelines for establishing profit objectives using the weighted guidelines method. DFARS 215.970-1(b)(3)(ii) states that contracting officers shall consider the amount of incurred costs prior to definitization before assigning the cost-risk element (contract type) of the profit objective. The DFARS prescribes that a contracting officer may assign a value as low as zero percent for contract-type risk where a substantial portion of the costs has been incurred prior to definitization. Further, DFARS 15.808, "Price Negotiation Memorandum," states that negotiation memorandums should fully document the rationale in

assigning various rates to the profit factors when using the weighted guidelines method.

Reduced contractor risk. Negotiation memorandums did not address the reduced risk of the contractor for incurred costs in 103 (72 percent) of 143 definitized contractual actions (Appendix A). The contracting officers developed higher-than-warranted profit objectives and awarded excessive profits to contractors in 60 instances where the contractual effort was complete, or substantially complete, at contract definitization.

For example, Contract F34601-88-G-6605, Order GB2D, that the Naval Aviation Supply Office awarded as a UCA on March 30, 1989, was 100 percent completed at the time of definitization on November 9, 1990. However, review of the price negotiation memorandum showed that the contractor was awarded a 15.5-percent profit rate even though the contractual requirements were completed by the definitization date. The contracting officer did not recognize or consider the reduced risks of the contractor in the profit development. In this instance, the awarded profit rate for this firm-fixed-price contractual action should have been no greater than that normally given for a cost-type contractual action (8 percent).

Under normal circumstances, a firm-fixed-price contract would be given a higher profit rate than a cost-type contract because the contractor assumes all the risk; however, this is not true for a UCA where the Government assumes most of the risk. Another example involved Contract N00024-84-C-2063, Modification A02023, that the SUPSHIP, Groton, Connecticut, awarded as a UCA on September 27, 1989. Although the contractor had incurred 100 percent of the costs at contract definitization (October 12, 1990), the contractor was given a higher-than-warranted profit rate of 15.3 percent.

Allowable profit. We determined that awarded profits exceeded the contractor's justifiable risk by $40.8 million (see summary at Appendix A). We determined the $40.8 million amount by allowing only an 8-percent profit rate on the costs incurred (exclusive of cost of money) at the definitization date. Incurred cost percentages for each UCA were determined by reviewing negotiation memorandums, analyzing public vouchers, progress payment requests, and holding discussions with DoD contracting personnel. We made no reduction in our computation of profits for the appropriate portion of costs yet to be incurred at the definitization date.

The contracting officers' documentation of profit in the negotiation memorandum was very cursory and did not contain a detailed narrative discussing how the objective and negotiated profit amounts and rates were developed. The negotiation

memorandums not only failed to mention the percentage of contractor incurred costs prior to the contract definitization date, but also failed to break-out and develop separate profit rates for the incurred costs and those costs yet to be incurred. Contracting personnel did not attempt to obtain contractor incurred cost data from appropriate sources either prior to or during final contractual negotiations. In addition, there was no documentary evidence in the negotiation memorandum to indicate that the Government had sufficiently reviewed incurred costs at definitization to ensure that the contractor had made any attempt to control these costs.

By not considering contractors' reduced cost risk in the definitization of UCAs, contracting officers awarded greater-than-warranted profits to DoD contractors. Also, there was no assurance that UCAs were being definitized at the most reasonable price to the Government. In addition, increased cost risk was assumed by DoD in the negotiation of UCAs.

Internal controls

The buying activities had little or no internal control over the award, obligation, and negotiation of UCAs. Specifically, internal controls did not provide techniques or procedures to effectively monitor and control UCAs to ensure that proper justification and approvals were obtained before issuance, that initial obligation restrictions were correct, that definitization was done in a timely manner, and that contracting officers adequately assessed and documented contractor incurred costs in negotiation memorandums.

The buying activities had no formal management control plans that covered the UCA process as a separate assessable internal control unit, and there was no evidence that current risk assessment reviews were specifically performed in this process. In addition, internal management information reports did not always provide DoD management with sufficient information to properly monitor and control UCAs. For example, our review of the internal controls at SPCC showed that no internal data base existed for tracking and monitoring open UCAs. Instead, UCAs were tracked through manually prepared listings, which were periodically updated by each contracting division. These manually prepared listings did not include all UCAs awarded at SPCC.

The majority of buying activities had no formal written internal control UCA objectives. Therefore, it was extremely difficult to evaluate the adequacy of the individual techniques used by buying activities to accomplish internal control objectives. Current UCA listings, maintained by buying activities, did not always contain sufficient information to adequately monitor and control the use of UCAs. For example, listings did not include not-to-exceed ceiling price amounts, obligated amounts,

contractor qualifying proposal dates, or designation of the contracting official responsible for the administration of the UCA. Without this information, management cannot adequately perform their oversight functions in the UCA process.

Adequate controls. The U.S. Army Missile Command (MICOM), did have adequate internal controls for monitoring and controlling UCAs, except for the consideration of contractors' incurred costs at the time of definitization. Specifically, MICOM contracting management placed a high degree of emphasis on managing and monitoring UCAs under its administrative control. Review of internal controls at MICOM showed that contracting personnel were aggressively complying with applicable internal Army guidance and DFARS requirements on UCAs. Although the UCA process was not considered a separate assessable internal control unit at MICOM, various internal control techniques were effectively utilized to monitor and manage this area. Specifically, a detailed monthly report was prepared that listed all open UCAs by responsible contract specialist, award date, contractor name, ceiling price, amount obligated, and milestone information on the status of proposal receipt, audit completion, and negotiation completion. A meeting was held each month at which time the monthly UCA status report was discussed in detail with emphasis on the failure to meet scheduled milestone dates.

During these monthly meetings, responsible contract specialists were required to provide current UCA status and specific reasons for any delay in definitization. Internal management controls were effective at MICOM, except in the area of considering incurred costs of contractors prior to definitization.

Change order modifications. Change order modifications issued pursuant to the contract "Changes" clause were not being properly managed and controlled as required by DFARS Subpart 217.75.

An unpriced change order modification represents a written order, signed by the contracting officer, directing the contractor to make a change under the contract "Changes" clause without the contractor's consent. Change order modifications occur more frequently in the shipbuilding and repair industry and to a lesser degree in the aircraft production industry. The frequency of change orders is high in the shipbuilding industry because of constant changes in engineering requirements. DFARS 217.7501, "Definitions," defines a contract action, for UCA purposes, as one that excludes contract modifications within the scope and under the terms of a contract, such as contract modifications issued pursuant to the "Changes" clause. Despite this exclusion, DFARS 217.7502, "Applicability," states that even changes under this clause are subject to the requirements and restrictions of UCAs to the maximum extent practicable.

During the audit, we informed the Navy that inconsistent UCA reporting existed at certain SUPSHIP locations. For example, specific reporting problems were observed at SUPSHIP, San Diego, California, where the number of reported UCAs increased by approximately 1,200 within 1 year. During a meeting at NAVSEA headquarters, Navy personnel stated that in the past, there has been inconsistent reporting of unpriced actions among individual SUPSHIPs. NAVSEA agreed to contact each SUPSHIP for the purpose of compiling a current listing of change order modifications by number and dollar amounts. NAVSEA stated that in the future all unpriced actions would be properly reported and the Navy's Contract Business Management reporting forms would be revised to permit identification and tracking of UCAs.

As shown in Appendix D, the problems with change order modifications are similar when compared with total sample results of UCAs (Appendix A). Appendix D also shows occurrences of contracting officers not effectively managing unpriced change order modifications to ensure that modifications were properly justified, that obligation limits were not being exceeded, that definitization was timely, and that allowable profits awarded contractors were based on the amount of costs incurred at definitization. The results in Appendix D were caused by inadequate control of contractual change order modifications by DoD.

RECOMMENDATIONS, MANAGEMENT COMMENTS, AND AUDIT RESPONSE

1. We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition), the Assistant Secretary of the Navy (Research, Development and Acquisition), and the Director of the Defense Logistics Agency:

a. Issue guidance to the heads of contracting and contract administration activities to establish procedures requiring compliance with the restrictions on the award, obligation, and negotiation of undefinitized contractual actions as contained in United States Code, title 10, section 2326 and Defense Federal Acquisition Regulation Supplement Subpart 217.75 (renumbered as Subpart 217.74).

Management comments. The Assistant Secretary of the Army (Research, Development and Acquisition) (RD&A) partially concurred with Recommendation 1.a. by proposing that a synopsized version of our findings be published in a future Army Materiel Command Acquisition Letter for the information of their contracting personnel. The Assistant Secretary of the Navy (Research, Development and Acquisition) (RD&A) partially concurred with Recommendation 1.a. by agreeing that within 30 days of receiving our final report, heads of contracting activities will be reminded to ensure that UCAs are issued in strict conformance with guidance and limitations of the DFARS and

the Navy Acquisition Procedures Supplement. The Assistant Secretary of the Navy also stated that UCAs will continue to be a special interest item on all Procurement Management Reviews. The Deputy Comptroller of the Defense Logistics Agency (DLA), nonconcurred with Recommendation 1.a., stating that there is adequate FAR, DFARS, Agency and local guidance already in place throughout DLA and that FAR 1.602-1(b) obviates the need for the guidance addressed in our recommendation.

Audit response. The actions taken and proposed by the Assistant Secretary of the Army and the Assistant Secretary of the Navy are responsive to Recommendation 1.a. if the Army Acquisition Letter communicates to the field activities that better implementation of the procedures is needed. Also, we request an estimated completion date from the Assistant Secretary of the Army for issuing an Acquisition Letter. We do not agree with the position of the Deputy Comptroller, DLA, on Recommendation 1.a. that guidance on the award, obligation, and negotiation of UCAs is not needed. Our audit showed that the only DLA buying activity reviewed, Defense Construction Supply Center, was not complying with the restrictions on the award, obligation, and negotiation of UCAs, while six DLA contract administration activities were not complying with the restrictions on the administration and negotiation of UCAs (see Footnotes 3 and 4 in Appendix A). Prior to issuance of the draft report, summaries of our UCA audit results by each contract were sent to each of the 19 Army, Navy, and DLA audit sites to obtain their comments. Review of the Army, Navy, and DLA comments resulted in the audit summaries in the draft report. Our review of the Deputy Comptroller, DLA management comments to the draft report resulted in the deletion of one of the three contracts reviewed at the Defense Construction Supply Center, which was awarded before receipt of DFARS UCA coverage. We request that the Deputy Comptroller, DLA, reconsider her position on Recommendation 1.a. when providing comments to the final report.

b. Issue guidance on the use of positive and negative incentives for obtaining contractor qualifying proposals in a more timely manner. The guidance should include use of incentives for reducing or suspending progress payments and accelerating definitization of undefinitized contractual actions.

Management comments. The Assistant Secretary of the Army, (RD&A) concurred with Recommendation 1.b. by commenting that the Army will search for available methods to provide incentives for contractors to submit qualifying proposals in a timely manner. The Navy partially concurred with Recommendation 1.b. by stating that policy and guidance on the use of positive and negative incentives should be issued but only by the Director of Defense Procurement since our recommendation has DoD-wide application.

The Deputy Comptroller, DLA, nonconcurred with Recommendation 1.b., saying that guidance on the use of positive and negative incentives was already in place for obtaining contractor qualifying proposals in a more timely manner.

Audit response. We agree with the Army response to research for available methods to provide incentives for contractors and request estimated completion dates. We also agree with the Navy response that guidance on the use of positive and negative incentives should be issued. The 1991 Edition of DFARS 217.74 permits the contracting officer to suspend or reduce progress payments, or take other appropriate action. We believe that each Military Department and Defense Agency is in the best position to determine what guidance should be issued to ensure appropriate implementation. We partially agree with the DLA position on Recommendation 1.b. that guidance is in place. However, we believe that additional guidance on positive and negative incentives for obtaining contractor qualifying proposals in a more timely manner should be issued. Our audit results of UCAs awarded, obligated and negotiated by both DLA buying and contracting administration activities showed that contracting officers were not always reducing or suspending progress payments and accelerating definitization of UCAs when necessary. We request that the Deputy Comptroller, DLA, reconsider her position on Recommendation 1.b. when providing comments to the final report.

c. Establish written internal control objectives and techniques that cover the award, obligation, and negotiation of undefinitized contractual actions. The guidance should require that:

i. Undefinitized contractual actions be made a separate assessable internal control unit subject to periodic risk assessment reviews, and

ii. Contracting personnel obtain written supervisory approval that the award, obligation, and negotiation of undefinitized contractual actions are in compliance with Defense Federal Acquisition Regulation Supplement Subpart 217.75.

Management comments. The Assistant Secretary of the Army, (RD&A) concurred with Recommendations 1.c.i. and 1.c.ii. by agreeing to add test questions on UCAs to the current Contract Office Management checklist in the Department of the Army Circular 11-91-1, "Internal Control Review Checklists." The Assistant Secretary of the Navy, (RD&A) partially concurred with Recommendation 1.c. by agreeing with the need for written internal control objectives and techniques that cover the award, obligation, and negotiation of UCAs. However, the Assistant Secretary of the Navy disagreed that these objectives and

techniques should be established on a Navy-wide basis and that contracting personnel should obtain written supervisory approval for every UCA. The Assistant Secretary of the Navy believed that adequate internal control objectives and techniques on the management of UCAs were in place at the head of contracting activity levels. The Deputy Comptroller, DLA, nonconcurred with Recommendations 1.c.i. and 1.c.ii. saying that comprehensive coverage was in place to cover the award, obligation, and negotiation of UCAs. The Deputy Comptroller also stated that further guidance for both the contracting offices and contracting administration activities was unnecessary and that there were no internal control deficiencies.

Audit response. The Assistant Secretary of the Army alternative actions meet the intent of Recommendations 1.c.i. and 1.c.ii., but we request estimated completion dates. We do not totally agree with the Assistant Secretary of the Navy response to Recommendation 1.c.i. that "guidance requiring UCAs be made a separate assessable internal control unit subject to periodic risk assessment reviews is not necessary." We partially disagree with the Assistant Secretary of the Navy response to Recommendation 1.c.ii. that contracting personnel should not be required to obtain written supervisory approval for every UCA as a matter of Navy-wide policy. We believe that this recommendation can be satisfied by simply adding a statement in the Business Clearance Memorandum for each UCA that the negotiation and definitization was in compliance with DFARS Subpart 217.75 (renumbered as Subpart 217.74). We request that the Assistant Secretary of the Navy reconsider his position on Recommendations 1.c.i. and 1.c.ii. when providing comments to the final report. We do not agree with the position of the Deputy Comptroller, DLA, on Recommendations 1.c.i. and 1.c.ii. that further guidance for both the contracting buying offices and contracting administration activities was unnecessary and that there were no internal control deficiencies. Our audit of a DLA buying office and DLA contracting administration activities showed that contracting personnel were not obtaining written supervisory approval that the award, obligation, and negotiation of UCAs were in compliance with DFARS Subpart 217.75 (renumbered as Subpart 217.74). We request that the Deputy Comptroller, DLA, reconsider her position on Recommendations 1.c.i. and 1.c.ii. when providing comments to the final report.

2. We recommend that the DoD Comptroller establish specific internal controls at DoD finance offices to prevent obligation of undefinitized contractual actions in excess of statutory limitations.

Management comments. The DoD Deputy Comptroller for Management Systems concurred with Recommendation 2. and stated that the Defense Finance and Accounting Service will establish specific internal controls at DoD finance offices to prevent obligation of UCAs in excess of statutory limitations. The Deputy Comptroller established an estimated completion date of April 1, 1992.

Revised recommendations. Based on comments received from management, we have deleted Recommendations 1.d. and 3. of the draft report. However, we have added a new Recommendation 3., to revise DFARS 217.7404-4, to this final report based on comments from the Director of Defense Procurement and discussions with the Office of the Secretary of Defense, General Counsel concerning the plain language of U.S.C., title 10, sec 2326(b), "Limitation on Obligation and Expenditure of Funds" (see Appendix I).

3. We recommend that the Director of Defense Procurement, Office of the Under Secretary of Defense for Acquisition direct the Defense Acquisition Regulations Council to revise Defense Federal Acquisition Regulation Supplement 217.7404-4, "Limitation on Expenditures," as follows:

217.7404-4 "Limitations on Obligation and Expenditure of Funds." The Government shall not obligate or expend more than 50 percent of the not-to-exceed price before definitization. However, if a contractor submits a qualifying proposal before 50 percent of the not-to-exceed price has been expended by the Government, then the limitation on obligations before definitization may be increased to no more than 75 percent.

RESPONSE REQUIREMENTS PER RECOMMENDATION

		Response Should Cover		
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date
1.a.	ASA(RD&A)			X
	Director, DLA	X	X	X
1.b.	ASA(RD&A)			X
	ASN(RD&A)	X	X	X
	Director, DLA	X	X	X
1.c.	ASA(RD&A)			X
	ASN(RD&A)	X	X	X
	Director, DLA	X	X	X
3.	Director, Defense Procurement	X	X	X

PART III - ADDITIONAL INFORMATION

APPENDIX A - Summary of Audit Results by Location and Total

APPENDIX B - Air Force Audit Agency Executive Summaries

APPENDIX C - Example of an Undefinitized Contractual Action

APPENDIX D - Summary of Audit Results - Change Order Modifications

APPENDIX E - United States Code, Title 10, Section 2326 - Undefinitized Contractual Actions: Restrictions

APPENDIX F - Summary of Benefits Resulting From Audit

APPENDIX G - Activities Visited or Contacted

APPENDIX H - Summary of Director of Defense Procurement Comments and Detailed Audit Responses

APPENDIX I - Report Distribution

APPENDIX A - SUMMARY OF AUDIT RESULTS BY LOCATION AND TOTAL

Locations 1/	Total Contractual Actions Reviewed	Actions not Definitized	Actions With-in Scope Changes	Total Ceiling Price Amount	Total Amount Definitized	Justification (Authorization) Adequate Yes	Justification (Authorization) Adequate No	Definitization Timely (180 Days) Yes	Definitization Timely (180 Days) No	Average Definitization Days	Amount by Which Initial Obligation Limit Exceeded Numbers	Amount by Which Initial Obligation Limit Exceeded Dollars	PNM 2/ Considered Incurred Costs Yes	PNM 2/ Considered Incurred Costs No	Excess Definitized Profit Amounts Based on (.08)(Incurred Cost)
Army:															
AMCCOM	7	0	0	$158,228,941	$155,103,335	7	0	4	3	225	1	$6,450,000	0	7	$2,789,674
TACOM	11	1	2	113,294,763	105,613,332	7	4	2	9	283	5	3,148,165	3	6	273,455
MICOM	18	0	0	472,553,274	518,380,302	18	0	13	5	141	0	0	5	13	11,650,944
CECOM	10	0	1	171,441,410	135,561,446	10	0	4	6	209	0	0	2	8	1,276,635
AVSCOM	8	0	0	1,029,431,068	1,066,713,685	8	0	2	6	282	0	0	6	2	14,664,225
TROSCOM	5	0	1	22,903,101	14,700,079	4	1	5	0	123	1	1,283,400	1	4	39,597
Army Totals	59	1	4	$1,967,852,557	$1,996,072,179	54	5	30	29	207	7	$10,881,565	17	40	$30,694,530
Navy:															
SPCC	6	2	0	$5,736,052	$4,039,429	0	6	0	6	585	6	$1,845,773	1	3	$97,281
SUPSHIP-GROTON	8	0	8	34,747,079	36,305,472	5	3	4	4	210	2	4,411,042	3	5	86,077
SUPSHIP-NEW ORLEANS	2	0	2	1,079,341	769,184	0	2	0	2	356	2	410,509	0	2	3,800
SUPSHIP-BATH	10	2	10	58,020,610	20,221,044	2	8	1	9	393	6	6,088,954	0	8	728,804
ASO	15	5	0	3,392,966	1,231,279	10	5	3	12	353	14	1,483,315	2	8	8,258
NAVAIR	5	0	0	189,038,010	187,659,483	3	2	1	4	281	4	43,252,205	3	2	4,508,270
DPRO-GE 3/	10	0	0	6,902,392	5,860,105	3	7	6	4	170	10	3,194,018	0	4	50,317
DPRO-PRATT & WHITNEY 3/	10	1	0	22,213,886	14,749,525	8	2	0	10	423	10	11,091,943	1	8	118,082
DPRO-McDONNELL DOUGLAS 3/	10	1	0	261,399,137	204,586,813	1	9	2	8	368	8	50,211,976	2	7	2,825,138
DPRO-GRUMMAN 3/	16	6	0	212,612,535	135,867,440	11	5	1	15	468	16	74,684,382	6	4	1,614,675
DCMAO-VAN NUYS 3/	10	2	0	3,179,481	817,029	3	7	4	4	179	9	1,551,276	2	5	
DCMAO-SAN FRANCISCO 3/	10	1	0	3,345,485	1,834,987	8	2	4	6	282	9	1,042,126	2	6	21,296
Navy Totals	112	20	20	$801,666,974	$613,941,790	54	58	26	84	342	96	$199,267,519	22	62	$10,061,998
Defense Logistics Agency:															
DCSC 4/	2	0	0	$628,550	$556,396	0	2	0	2	263	2	$211,900	1	1	$6,942
Defense Logistics Agency Totals	2	0	0	$628,550	$556,396	0	2	0	2	263	2	$211,900	1	1	$6,942
Total - All Locations	173	21	24	$2,770,148,081	$2,610,570,365	108	65	56	115	295	105	$210,360,984	40	103	$40,763,470
Percents							38		67		61			72	

1/ See Location key at end of Appendix.
2/ PNM - Price Negotiation Memorandum.
3/ Navy contracts wherein the Navy awarded and funded the UCAs while either the Navy, the Air Force, or the Defense Logistics Agency administered and negotiated the UCAs.
4/ Defense Logistics Agency contracts wherein the Defense Logistics Agency awarded, funded, administered and negotiated the UCAs.

APPENDIX A - SUMMARY OF AUDIT RESULTS BY LOCATION AND TOTAL
(cont'd)

Location Key:

AMCCOM = U.S. Army Armament, Munitions and Chemical Command, Rock Island, IL
TACOM = U.S. Army Tank-Automotive Command, Warren, MI
MICOM = U.S. Army Missile Command, Redstone Arsenal, AL
CECOM = U.S. Army Communications and Electronics Command, Fort Monmouth, NJ
AVSCOM = U.S. Army Aviation Systems Command, St. Louis, MO
TROSCOM = U.S. Army Troop Support Command, St. Louis, MO
SPCC = Navy Ships Parts Control Center, Mechanicsburg, PA
SUPSHIP-GROTON = Supervisor of Shipbuilding, Groton, CT
SUPSHIP-NEW ORLEANS = Supervisor of Shipbuilding, New Orleans, LA
SUPSHIP-BATH = Supervisor of Shipbuilding, Bath, ME
ASO = Aviation Supply Office, Philadelphia, PA
NAVAIR = Naval Air Systems Command, Washington, DC
DPRO-GE = Defense Plant Representative Office - General Electric Company, Lynn, MA
DPRO-PRATT & WHITNEY = Defense Plant Representative Office - Pratt and Whitney Aircraft Group, West Palm Beach, FL
DPRO-McDONNELL DOUGLAS = Defense Plant Representative Office - McDonnell Douglas Corporation, St. Louis, MO
DPRO-GRUMMAN = Defense Plant Representative Office - Grumman Aerospace Corporation, Long Island, NY
DCMAO-VAN NUYS = Defense Contract Management Area Operations - Van Nuys, CA
DCMAO-SAN FRANCISCO = Defense Contract Management Area Operations - San Francisco, CA
DCSC = Defense Construction Supply Center, Columbus, OH

APPENDIX B - AIR FORCE AUDIT AGENCY EXECUTIVE SUMMARIES

MANAGEMENT OF UNDEFINITIZED CONTRACTUAL ACTIONS IN AIR FORCE LOGISTICS AND SYSTEMS COMMANDS PROJECT NUMBERS 9046413 AND 9046410

OVERALL EVALUATIONS

AFLC policies and procedures to manage UCAs were not effective. Inaccurate information was included on the UCA report for 50 percent of the UCAs reviewed. Also, in 42 percent of the cases reviewed, information provided to justify the use of UCAs did not adequately demonstrate that the situations involved were sufficiently urgent to warrant this type of procurement action. In addition, UCAs were not definitized within the required 180-day time period on 75 percent of the actions covered in the audit; the definitization dates for the delinquent actions ranged from 6 to 1,051 days late, and averaged 134 days past the 180-day limit. Further, contracting officials did not obtain written approvals to extend the definitization schedules for 90 percent of the UCAs definitized later than the due dates. Finally, contracting officers did not properly consider incurred costs to compute profit factors for 20 percent of the UCAs reviewed, and contracting officials obligated more than 50 percent of the estimated contract price without justification on 20 percent of the actions audited.

AFSC policies and procedures to control and manage UCAs were not effective. Specifically, UCA reporting was neither meaningful (procurement officials did not report 39 percent of the contractual actions reviewed) nor accurate (reported information was in error for 23 percent of the UCAs reviewed). Also, in 68 percent of the cases reviewed, justification for using UCAs was neither adequate nor valid. In addition, definitization for 86 percent of the UCAs did not occur within the required time and funding limitations. We also found that negotiation teams did not adequately consider incurred costs when determining contractor risk to establish the profit objective for 35 percent of the UCAs, resulting in potential excess profits totalling about $1.2 million. Further, the results of a Space Systems Division installation-level review found that adequate controls were not applied to limit obligations or expenditures for 28 percent of Titan IV UCAs issued under the contract changes clause.

APPENDIX C - EXAMPLE OF AN UNDEFINITIZED CONTRACTUAL ACTION

Contract Description. On March 15, 1989, Contract N00383-88-G-B380, Order 0098 was awarded as a UCA by the Naval Aviation Supply Office, Philadelphia, Pennsylvania, to the Pratt & Whitney Government Engine Group, West Palm Beach, Florida, at a not-to-exceed ceiling price of $7,810,550. The contract, administered by the Defense Plant Representative Office Pratt & Whitney, West Palm Beach, Florida, was for the delivery of 1,291 nozzle and support assemblies in support of the J-52 engine.

Justification (Authorization) for Award. In this instance, the UCA justification was considered adequate since the authorization contained a narrative statement fully explaining the necessity to award a UCA in accordance with the policy guidance contained in DFARS 217.7503(a), "General Policy."

Obligation and Expenditure of Ceiling Price Amount. The entire not-to-exceed ceiling price amount of $7,810,550 was obligated when the UCA was awarded on March 15, 1989 (contractor qualifying proposal was dated May 26, 1989). DFARS 217.7503(b)(4), "Limitation on Expenditures," requires that no more than 50 percent of the not-to-exceed price shall be expended (obligated) by the Government until the UCA is definitized. In this instance, the initial 50 percent obligation amount was exceeded by $3,905,275.

UCA Definitization. It took 459 days to definitize this UCA as calculated from the date of the qualifying proposal of May 26, 1989, to the definitization date of August 28, 1990. The definitized amount of $5,777,909 was $2,032,641 less than the initial obligated amount of $7,810,550. DFARS 217.7503(b)(3)(i), "Definitization Schedule," requires that UCAs shall be definitized within a 180-day period beginning on the date the contractor submits a qualifying proposal.

Determination of Allowable Profit. DFARS 217.7503(b)(8), "Allowable Profit," requires that profit allowed on a negotiated UCA should reflect the reduced cost risk of the contractor with regard to incurred costs at final definitization. In this instance, the contractor was awarded the proposed profit rate of 12.8 percent even though the contract was 42 percent complete. The contractor was therefore awarded a profit amount that did not correspond with the reduced cost risk.

APPENDIX D - SUMMARY OF AUDIT RESULTS - CHANGE ORDER MODIFICATIONS

Locations 1/	With-in Scope Changes	Total Ceiling Price Amount	Total Amount Definitized	Justification (Authorization) Adequate Yes	Justification (Authorization) Adequate No	Definitization Timely (180 Days) Yes	Definitization Timely (180 Days) No	Average Definitization Days	Amount by Which Initial Obligation Limit Exceeded Numbers	Amount by Which Initial Obligation Limit Exceeded Dollars	PNM 2/ Considered Incurred Costs Yes	PNM 2/ Considered Incurred Costs No	Excess Definitized Profit Amounts Based on (.08)(Incurred Cost)
Army:													
TACOM	2	$1,142,523	$1,155,563	1	1	1	1	147	0	$0	1	0	$0
CECOM	1	5,399,000	3,945,272	1	0	0	1	288	0	0	0	1	88,124
TROSCOM	1	1,377,496	1,162,207	1	0	1	0	123	0	0	0	1	0
Army Totals	4	$7,919,019	$6,263,042	3	1	2	2	176	0	$0	1	2	$88,124
Navy:													
SUPSHIP-GROTON	8	$34,747,079	$36,305,472	5	3	4	4	210	2	$4,411,042	3	5	$86,077
SUPSHIP-NEW ORLEANS	2	1,079,341	769,184	0	2	0	2	356	2	410,509	0	2	3,800
SUPSHIP-BATH	10	58,020,610	20,221,044	2	8	1	9	393	6	6,088,954	0	8	728,804
Navy Totals	20	$93,847,030	$57,295,700	7	13	5	15	316	10	$10,910,505	3	15	$818,681
Total - All Locations	24	$101,766,049	$63,558,742	10	14	7	17	293	10	$10,910,505	4	17	$906,805
Percents					58		71		42			81	

1/ See Location key at end of Appendix.
2/ PNM - Price Negotiation Memorandum.

Note: The above results are also included as part of the overall summary of audit results as shown in Appendix A.

APPENDIX D - SUMMARY OF AUDIT RESULTS - CHANGE ORDER MODIFICATIONS (cont'd)

Location Key:

TACOM = U.S. Army Tank-Automotive Command, Warren, MI
CECOM = U.S. Army Communications and Electronics Command, Fort Monmouth, NJ
TROSCOM = U.S. Army Troop Support Command, St. Louis, MO
SUPSHIP-GROTON = Supervisor of Shipbuilding, Groton, CT
SUPSHIP-NEW ORLEANS = Supervisor of Shipbuilding, New Orleans, LA
SUPSHIP-BATH = Supervisor of Shipbuilding, Bath, ME

10 USC 2326

"§ 2326. Undefinitized contractual actions: restrictions

"(a) IN GENERAL.—The head of an agency may not enter into an undefinitized contractual action unless the request to the head of the agency for authorization of the contractual action includes a description of the anticipated effect on requirements of the military department concerned if a delay is incurred for purposes of determining contractual terms, specifications, and price before performance is begun under the contractual action.

"(b) LIMITATIONS ON OBLIGATION AND EXPENDITURE OF FUNDS.—(1) A contracting officer of the Department of Defense may not enter into an undefinitized contractual action unless the contractual action provides for agreement upon contractual terms, specifications, and price by the earlier of—

"(A) the end of the 180-day period beginning on the date on which the contractor submits a qualifying proposal to definitize the contractual terms, specifications, and price; or

"(B) the date on which the amount of funds obligated or expended under the contractual action is equal to more than 50 percent of the negotiated overall ceiling price for the contractual action.

"(2) Except as provided in paragraph (3), the contracting officer for an undefinitized contractual action may not expend with respect to such contractual action an amount that is equal to more than 50 percent of the negotiated overall ceiling price until the contractual terms, specifications, and price are definitized for such contractual action.

"(3) If a contractor submits a qualifying proposal (as defined in subsection (g)) to definitize an undefinitized contractual action before an amount equal to more than 50 percent of the negotiated overall ceiling price is expended on such action, the contracting officer for such action may not expend with respect to such contractual action an amount that is equal to more than 75 percent of the negotiated overall ceiling price until the contractual terms, specifications, and price are definitized for such contractual action.

"(4) This subsection does not apply to an undefinitized contractual action for the purchase of initial spares.

"(c) INCLUSION OF NON-URGENT REQUIREMENTS.—Requirements for spare parts and support equipment that are not needed on an urgent basis may not be included in an undefinitized contractual action for spare parts and support equipment that are needed on an urgent basis unless the head of the agency approves such inclusion as being—

"(1) good business practice; and

"(2) in the best interests of the United States.

"(d) MODIFICATION OF SCOPE.—The scope of an undefinitized contractual action under which performance has begun may not be modified unless the head of the agency approves such modification as being—

"(1) good business practice; and

"(2) in the best interests of the United States.

"(e) ALLOWABLE PROFIT.—The head of an agency shall ensure that the profit allowed on an undefinitized contractual action for which the final price is negotiated after a substantial portion of the performance required is completed reflects—

"(1) the possible reduced cost risk of the contractor with respect to costs incurred during performance of the contract before the final price is negotiated; and

"(2) the reduced cost risk of the contractor with respect to costs incurred during performance of the remaining portion of the contract.

"(f) APPLICABILITY.—This section does not apply to the Coast Guard or the National Aeronautics and Space Administration.

"(g) DEFINITIONS.—In this section:

"(1) The term 'undefinitized contractual action' means a new procurement action entered into by the head of an agency for which the contractual terms, specifications, or price are not agreed upon before performance is begun under the action. Such term does not include contractual actions with respect to the following:

"(A) Foreign military sales.

"(B) Purchases of less than $25,000.

"(C) Special access programs.

"(D) Congressionally-mandated long-lead procurement contracts.

"(2) The term 'qualifying proposal' means a proposal that contains sufficient information to enable the Department of Defense to conduct complete and meaningful audits of the information contained in the proposal and of any other information that the Department is entitled to review in connection with the contract, as determined by the contracting officer.".

APPENDIX F - SUMMARY OF BENEFITS RESULTING FROM AUDIT

Recommendation Reference	Description of Benefit	Type of Benefit
1.a., 1.b.	Full contracting officer compliance with Public Law and DFARS regulations and greater use of various incentive techniques will result in effective management of UCAs.	Undeterminable
1.c.	Establishment of adequate internal control objectives and techniques will ensure that UCAs are properly awarded, obligated, and negotiated in a timely manner.	Nonmonetary
2.	Establishment of adequate internal controls at DoD finance offices will ensure that UCAs are properly obligated.	Nonmonetary
3.	Revision of DFARS Subpart 217.74 section on UCA obligations and expenditures will ensure that funds obligated for UCAs do not exceed statutory limitations.	Nonmonetary

APPENDIX G - ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Director of Defense Procurement, Washington, DC
Comptroller of the Department of Defense, Washington, DC
Director, Defense Acquisition Regulations System, Washington, DC

Department of the Army

Assistant Secretary of the Army (Financial Management), Washington, DC
Assistant Secretary of the Army (Research, Development and Acquisition), Washington, DC
Headquarters, U.S. Army Materiel Command, Alexandria, VA
- U.S. Army Armament, Munitions and Chemical Command, Rock Island, IL
- U.S. Army Tank-Automotive Command, Warren, MI
- U.S. Army Missile Command, Redstone Arsenal, AL
- U.S. Army Communications and Electronics Command, Fort Monmouth, NJ
- U.S. Army Aviation Systems Command, St. Louis, MO
- U.S. Army Troop Support Command, St. Louis, MO

Department of the Navy

Assistant Secretary of the Navy (Financial Management), Washington, DC
Assistant Secretary of the Navy (Research, Development and Acquisition), Washington, DC
Headquarters, Naval Air Systems Command, Washington, DC
Headquarters, Naval Sea Systems Command, Washington, DC
Navy Ships Parts Control Center, Mechanicsburg, PA
Supervisor of Shipbuilding, Groton, CT
Supervisor of Shipbuilding, Bath, ME
Supervisor of Shipbuilding, New Orleans, LA
Aviation Supply Office, Philadelphia, PA

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller), Washington, DC
Air Force Audit Agency, Wright-Patterson Air Force Base, OH

Defense Agencies

Headquarters, Defense Contract Audit Agency, Alexandria, VA
Headquarters, Defense Finance and Accounting Service, Washington, DC

APPENDIX G - ACTIVITIES VISITED OR CONTACTED (cont'd)

Headquarters, Defense Logistics Agency, Alexandria, VA
- Defense Construction Supply Center, Columbus, OH
- Defense Industrial Supply Center, Philadelphia, PA
- Defense Contract Management Command
  - Defense Plant Representative Office - General Electric Company, Lynn, MA
  - Defense Plant Representative Office - Pratt and Whitney Aircraft Group, West Palm Beach, FL
  - Defense Plant Representative Office - McDonnell Douglas Corporation, St. Louis, MO
  - Defense Plant Representative Office - Grumman Aerospace Corporation, Long Island, NY
  - Defense Contract Management Area Operations - Van Nuys, CA
  - Defense Contract Management Area Operations - San Francisco, CA

Non-DoD Federal Organizations

U.S. General Accounting Office, Washington, DC

APPENDIX H - SUMMARY OF DIRECTOR OF DEFENSE PROCUREMENT COMMENTS AND DETAILED AUDIT RESPONSES

1. **Director of Defense Procurement (DDP) comment**. The Director strenuously disagreed that DoD was not properly managing UCAs as required by Section 908 of Public Law 99-661 and pointed out that total DoD UCA dollars from 1985 to 1988 had been reduced by 67 percent.

> **Audit response**. In the Executive Summary we credit DoD for reducing both the number and dollar value of UCAs since the mid-1980's. The significant reduction in UCAs during the late-1980's by DoD is commendable, but it was primarily caused by Congressional concern and the enactment of Public Law 99-661, which limited the number and dollar value of UCAs. Our audit of FYs 1988 and 1989 UCAs showed that even at the lower UCA levels, DoD was still not properly managing UCAs as required by the applicable statutory and regulation requirements.

2. **DDP comment**. The Director was concerned that our review included "within scope" change orders, which are specifically excluded from the DFARS definition of UCAs. The Director stated that there is a less stringent standard for "within scope" change orders than that which is applicable to UCAs.

> **Audit response**. We agree with the Director that the requirements for controlling "within scope" change orders would have a less stringent standard than UCAs since the change orders are specifically excluded as UCAs in the DFARS. However, this exclusion for change orders is only in the DFARS, not specifically identified as such in U.S.C., title 10 sec. 2326. Our audit showed that similar management problems and increased cost risk to DoD exist with "within scope" change orders as with UCAs. Therefore, we believe that DoD contracting officers should be applying the policies and procedures of UCAs to "within scope" change orders to the maximum extent practicable as provided by DFARS 217.7402. Also we found instances of inconsistent identification, reporting, and tracking of UCAs, including "within scope" change orders, at certain SUPSHIP locations. A possible solution to the above cited problems may be to specifically include "within scope" change orders under the UCA definition in DFARS 217.74.

3. **DDP comment**. The Director stated that our audit report reflected a fundamental misunderstanding of the meaning of DFARS 217.7503(b)(4), "Limitation on Expenditures." The Director also stated that the limitations set out in DFARS 217.7503(b)(4) apply to Government expenditures only, and not to obligation of funds. The Director further stated that the new DFARS 217.7404-4 was

inadvertently published using the word "obligations" instead of "expenditures" and that a correction will be made prior to the effective date of December 31, 1991.

> **Audit response**. We believe that there is no misunderstanding on our part as to the meaning of the statutory requirements at subsection (b) of U.S.C., title 10, sec 2326 (that implemented Section 908 of Public Law 99-661). This subsection is clearly titled "(b) Limitations on obligation and expenditure of funds." Subsection (b)(1) also refers to the amount of funds obligated or expended in discussing when a DoD contracting officer may enter into a UCA. There is no question on our part that limitations in DFARS 217.7503(b)(4) should have applied to both Government obligations and expenditures and not just to Government expenditures. We believe that the control of the obligation of funds was an integral part of the internal controls established by the law. Our Recommendation 3., which was added to the final report, will ensure that the new DFARS 217.7404-4 version expresses the plain language of the statutory requirements of U.S.C., title 10, sec. 2326(b).

4. **DDP comment**. The Director commented that our draft report reflected a misunderstanding of the requirements for timely definitization of UCAs. The Director stated that the 180-day definitization limit is not absolute and may be extended as long as this extension does not exceed the statutory limit of 180 days after the contractor submits a qualifying proposal.

> **Audit response**. Our draft report results did consider the submission of contractor qualifying proposals after the UCA award date in determining timely definitization of UCAs (based on the 180-day definitization limit). Also, we saw no legitimate documentation supporting extensions in the UCA files and negotiation records.

APPENDIX I - REPORT DISTRIBUTION

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition
Assistant Secretary of Defense (Production and Logistics)
Director of Defense Procurement
Comptroller of the Department of Defense
Director, Defense Acquisition Regulations Systems

Department of the Army

Secretary of the Army
Assistant Secretary of the Army (Financial Management)
Assistant Secretary of the Army (Research, Development and Acquisition), Washington, DC
Auditor General, U.S. Army Audit Agency

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Assistant Secretary of the Navy (Research, Development and Acquisition), Washington, DC
Comptroller of the Navy
Auditor General, Naval Audit Service
Headquarters, Naval Sea Systems Command
Headquarters, Naval Air Systems Command

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Air Force Audit Agency

Defense Activities

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency

Non-DoD

Office of Management and Budget
U.S. General Accounting Office, NSIAD Technical Information Center

Congressional Committees:
- Senate Subcommittee on Defense, Committee on Appropriations
- Senate Committee on Armed Services
- Senate Committee on Governmental Affairs
- Ranking Minority Member, Senate Committee on Armed Services
- House Committee on Appropriations
- House Subcommittee on Defense, Committee on Appropriations
- Ranking Minority Member, House Committee on Appropriations
- House Committee on Armed Services
- House Committee on Government Operations
- House Subcommittee on Legislation and National Security, Committee on Government Operations

PART IV - MANAGEMENT COMMENTS

Director of Defense Procurement

Comptroller of the Department of Defense

Assistant Secretary of the Army (Research, Development and Acquisition)

Assistant Secretary of the Navy (Research, Development and Acquisition)

Deputy Comptroller, Defense Logistics Agency

DIRECTOR OF DEFENSE PROCUREMENT COMMENTS

OFFICE OF THE UNDER SECRETARY OF DEFENSE

WASHINGTON, DC 20301-3000

ACQUISITION
DP/CPF

NOV 15 1991

MEMORANDUM FOR DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE, OFFICE OF THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Draft Report on the Audit on Undefinitized Contractual Actions (Project No. OCA-0051)

As requested in your letter of September 17, 1991, we have carefully reviewed your subject draft audit report. While the report contained no recommendations specifically directed to this office, we are obliged to comment on a number of problems which we found in it.

At the outset, we must strenuously disagree with the overall assessment that DoD is not properly managing undefinitized contractual actions (UCAs) as required by Section 908 of Public Law 99-661. Since the mid-1980s, DoD has devoted considerable management attention to ensuring the proper use of UCAs. The results are clearly evident in the subsequent dramatic reduction in both the use and number of UCAs within the Department. From a high point of $27.9 billion as of September 30, 1985, total DoD UCAs on hand were brought down to $9.3 billion as of September 30, 1988--an impressive 67 percent reduction in only three years.

While your draft report contains a brief reference to this important accomplishment in its Executive Summary, the remainder of the report is highly critical of DoD's management of UCAs. It is totally incongruous to assert that there could have been widespread noncompliance with the very regulations that were instituted to limit the use of UCAs and to shorten definitization times, at the same time DoD was making such significant strides in reducing its backlog of UCAs. Clearly, we could not have made the tremendous progress which we have in this area without very careful management scrutiny of the necessity for awarding new UCAs, as well as vigorous management attention to the prompt definitization of existing UCAs.

We are also concerned by the inclusion of "within scope" change orders in your review. Such change orders are specifically excluded from the Defense Federal Acquisition Regulation Supplement (DFARS) definition of UCAs. While DFARS 217.7502 states that changes under the Changes clause are to be handled in accordance with the UCA

requirements in Subpart 217.75 "to the maximum extent practical," it should be clearly understood that this is a less stringent standard than that which is applicable to UCAs. Otherwise, there would be no reason to exclude such change orders from the definition of UCAs. Moreover, your draft report contains no analysis of whether there were any compelling factors which might have justified the alleged mismanagement of the change orders included in your audit sample under this "maximum extent practical" standard. For these reasons, we find that the inclusion of "within scope" change orders in your audit of UCAs seriously undermines its credibility.

As the office with the primary responsibility within DoD for the promulgation and interpretation of procurement regulations, we must point out that your audit report reflects a fundamental misunderstanding of the meaning of DFARS 217.7503(b)(4), "Limitation on Expenditures." That paragraph states:

> No more than 50 percent of the not-to-exceed price for the UCA shall be expended by the Government until the contract terms, specifications, and price are definitized. However, if a contractor submits a qualifying proposal to definitize the UCA before 50 percent of the not-to-exceed price is expended by the Government, no more than 75 percent of the not-to-exceed price may be expended by the Government until the contract terms, specifications, and price are definitized. (Emphasis added)

Notwithstanding this seemingly clear guidance, a substantial portion of your report focuses on the alleged over-obligation of funds by DoD contracting officers. The limitations set out in DFARS 217.7503(b)(4) apply to Government expenditures only, and not to the obligation of funds. Moreover, we believe that this regulation accurately reflects the statutory language at 10 U.S.C. 2326(b)(2) and (3). While some of the confusion in this area may be traceable to the DAR Council's initial Departmental Implementation Letter of April 13, 1987, which briefly established a limitation on both obligations and expenditures for UCAs, the DAR Council subsequently adopted the above cited language in the 1988 DFARS. We believe that it would be grossly unfair to expect our contracting officers to have followed any other standard than that set out at DFARS 217.7503(b)(4).

Your draft report suggests that the new DFARS 217.7404-4 language, which is not effective until December 31, 1991, will clearly establish limitations on both obligations and expenditures for UCAs. This is because the new DFARS 217.7404-4 was inadvertently published using the word "obligations" in one instance where it should have contained the word "expenditures." We must advise you,

however, there was never any intention by the DAR Council to change DoD policy in this area from that currently found at DFARS 217.7503(b)(4). Accordingly, the incorrectly used word "obligations" will be changed to "expenditures" in the new DFARS 217.7404-4 prior to its effective date.

Your draft report also reflects a misunderstanding of the requirements for timely definitization of UCAs. DFARS 217.7503(b)(3) requires that a schedule be established which provides for definitization of a UCA by the earlier of 180 days after its award or the date on which funds expended are equal to 50 percent of its not-to-exceed price. However, the 180-day limit is not absolute and may be extended, as required, so long as the extension does not exceed the statutory limit of 180 days after the contractor submits a qualifying proposal (10 U.S.C. 2326(b)(1)(A)). Unfortunately, your draft report contains no analysis of whether there may have been legitimate reasons for extending the original 180-day definitization schedule where that period was exceeded in your audit sample.

We appreciate the opportunity to review your draft audit report, and we hope you will carefully consider our comments as you finalize that report.

Eleanor R. Spector
Director, Defense Procurement

COMPTROLLER OF THE DEPARTMENT OF DEFENSE COMMENTS

OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

(Management Systems)

MEMORANDUM FOR DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE, ODODIG

SUBJECT: Audit Report on Undefinitized Contractual Actions (Project NO. OCA-051)

By memorandum dated September 17, 1991, you requested comments on the recommendations contained in the subject audit report.

There was one recommendation addressed to the Department of Defense Comptroller, and we concur in that recommendation. Our response is attached.

The Defense Finance and Accounting Service has agreed to take the lead in developing the recommended internal controls. Any future correspondence on implementation of the recommendation should be addressed to the Deputy Director for Accounting, Defense Finance and Accounting Service.

Questions pertaining to this response may be directed to Ms. Susan M. Williams, of my staff, at (703) 697-0537.

Alvin Tucker
Deputy Comptroller
(Management Systems)

Attachment

cc: Director, DFAS

DOD, IG DRAFT AUDIT REPORT (PROJECT NO. OCA-0051)

DATED SEPTEMBER 17, 1991

"AUDIT OF UNDEFINITIZED CONTRACTUAL ACTIONS"

DOD COMPTROLLER RESPONSE

RECOMMENDATION

2. We recommend that the DoD Comptroller establish specific internal controls at DoD finance offices to prevent obligation of undefinitized contractual actions in excess of statutory limitations.

DoD Comptroller Response. Concur. The Defense Finance and Accounting Service will take the lead in developing the specific internal controls to prevent future occurrence of the deficiencies described in the recommendation. The estimated completion date is April 1, 1992.

ASSISTANT SECRETARY OF THE ARMY (RESEARCH, DEVELOPMENT AND ACQUISITION) COMMENTS

DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY
U.S. ARMY CONTRACTING SUPPORT AGENCY
5109 LEESBURG PIKE
FALLS CHURCH, VIRGINIA 22041-3201

REPLY TO ATTENTION OF

SFRD-KP

15 NOV 1991

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE, ATTN: AUDITING, 400 ARMY NAVY DRIVE, ARLINGTON VIRGINIA 22202-2884

SUBJECT: Draft Audit Report on Undefinitized Contractual Actions (Project No. OCA-0051)

Reference is made to your September 17, 1991, memorandum on the subject report which requests comments on the draft findings and recommendations.

We concur with the findings reported in the draft report. U.S. Army Materiel Command (AMC) issued guidance regarding limitations on obligation of funds for undefinitized contract actions (UCAs) on August 7, 1991, and they expect to publish internal control policy on UCAs in December 1991.

The following comments are offered on the recommendations for corrective action.

1.a. We believe that the regulatory coverage at FAR 16.603 and DFARS 217.75 provides ample guidance for contracting officers about the restrictions on the award, obligation, and negotiation of UCAs. Although we believe that additional procedural instructions "requiring compliance" with the FAR and DFARS coverage are unnecessary, we recommend that a synopsized version of your findings should be published in a future AMC Acquisition Letter for the information of their contracting personnel.

1.b. We will search for available methods to incentivize contractors to submit qualifying proposals in a timely manner.

1.c. Agree to add test questions on UCAs to the current Contract Office Management checklist in the Department of the Army Circular 11-91-1, "Internal Control Review Checklists." This will be in lieu of the recommendations in subparagraphs "i" and "ii."

1.d. We do not agree that it is necessary for HCAs to specifically certify that their undefinitized contract actions have been accomplished in accordance with law and regulation. The remedies agreed upon here will suffice.

Draft report Recommendation 1.d. deleted from final report.

Draft report Recommendation 3. deleted from final report.

SFRD-KP
SUBJECT: Draft Audit Report on Undefinitized Contractual Actions (Project No. OCA-0051)

3.0. Your draft report reveals weaknesses at some AMC major subordinate commands, and we agree that their commander may report those weaknesses for insertion in the next annual statement of assurance. We do not believe that your findings support a conclusion that there is a major inherent risk, Army-wide, that prescribed procedures do not provide reasonable assurance that internal controls are in place and working to combat that risk. Therefore, a report by the Assistant Secretary of the Army (Research, Development and Acquisition) on the weakness in the annual statement is not warranted.

Point of contact is Ray Kelly, (703) 756-7563.

J. Bruce King
Acting Director

CF:
AMCPP
SAIG-PA
SARD-DER

2

ASSISTANT SECRETARY OF THE NAVY (RESEARCH, DEVELOPMENT AND ACQUISITION) COMMENTS

THE ASSISTANT SECRETARY OF THE NAVY
(Research, Development and Acquisition)
WASHINGTON, D C 20350-1000

NOV 26 1991

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: AUDIT REPORT ON UNDEFINITIZED CONTRACTUAL ACTIONS (PROJECT NO. OCA-0051)

Ref: (a) DoDIG Memorandum of 17 Sep 1991; same subject

Encl: (1) DoN Response to DoDIG Draft Audit Report No. OCA-0051

This is the Navy response to the subject audit report concerning the management of undefinitized contractual actions.

As noted in the report, the audit was performed during the period June 1990 through May 1991 and covered UCAs issued during fiscal years 1988 and 1989. During this same time period, several initiatives were undertaken that had a positive impact on the management and processing of UCAs within the Department of the Navy. These initiatives are reflected in our comments provided in enclosure (1).

Gerald A. Cann

Department of the Navy
Response to
DoDIG Draft Audit Report No. OCA-0051
"Undefinitized Contractual Actions"
17 September 1991

RECOMMENDATIONS FOR CORRECTIVE ACTION

Recommendation 1.

We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition), the Assistant Secretary of the Navy (Research, Development and Acquisition), and the Director of the Defense Logistics Agency

a. issue guidance to the heads of contracting and contract administration activities to establish procedures requiring compliance with the restrictions on the award, obligation, and negotiation of undefinitized contractual actions as contained in United States Code, title 10, section 2326, and Defense Federal Acquisition Regulation Supplement Subpart 217.75.

b. issue guidance on the use of positive and negative incentives for obtaining contractor qualifying proposals in a more timely manner. The guidance should include use of incentives for reducing or suspending progress payments and accelerating definitization of undefinitized contractual actions.

c. establish written internal control objectives and techniques that cover the award, obligation, and negotiation of undefinitized contractual actions. The guidance should require that:

i. Undefinitized contractual actions be made a separate assessable internal control unit subject to periodic risk assessment reviews, and

ii. Contracting personnel obtain written supervisory approval that the award, obligation, and negotiation of undefinitized contractual actions are in compliance with Defense Federal Acquisition Regulation Supplement Subpart 217.75.

Draft report Recommendation 1.d. deleted from final report.

d. establish procedures for the heads of the contracting activities to certify annually that undefinitized contractual actions have been properly identified and managed in accordance with the requirements and restrictions contained in United States Code, title 10, section 2326 and Defense Federal Acquisition Regulation Supplement Subpart 217.75.

DoN Position:

1.a. Partially Concur - We do not believe that Navy-wide procedures are necessary to achieve compliance with the restrictions on the award, obligation, and negotiation of

undefinitized contractual actions (UCAs). Guidance pertaining to UCAs may be found in Subpart 217.75 of the Defense Federal Acquisition Regulation Supplement (DFARS) (1991 edition) as well as Subparts 17.75 and 43.2 of the Navy Acquisition Procedures Supplement (NAPS). This guidance, in consonance with existing management controls, is considered adequate to ensure compliance with the restrictions on the award, obligation, and negotiation of UCAs. However, within 30 days of receipt of your final report, we will remind our HCAs of the need to ensure that UCAs are issued in strict conformance with the guidance and limitations of the DFARS and the NAPS. We will also ask that UCAs continue to be a special interest item on all Procurement Management Reviews (PMRs).

1.b. Partially Concur - We concur with this recommendation except that the policy/guidance should be issued by the Director, Defense Procurement since the recommendation has DoD-wide application. Any policy/guidance affecting progress payments or a contractor's cash flow would require publication in the Federal Register for public comment since it would have a significant cost impact on contractors. This properly should be done once at the DoD level rather than separately by each Military Department and Defense Agency.

1.c. Partially Concur - We concur with the need for written internal control objectives and techniques that cover the award, obligation, and negotiation of undefinitized contractual actions. However, we do not agree that specific internal control objectives and techniques should be established at the Navy Secretariat level on a Navy-wide basis. Further, we do not agree that contracting personnel should obtain written supervisory approval for every UCA as a matter of Navy-wide policy. Subpart 4.90 of the NAPS requires HCAs to ensure that records are maintained that include information on undefinitized changes, maximum priced orders, letter contracts, contract administration services, and general contracting workload. Further, subparts 17.75 and 43.2 of the NAPS require management emphasis on UCAs and undefinitized change orders, respectively. As a example of providing this management emphasis, the Naval Air Systems Command has six separate reports on UCAs in its Management Information Systems' Executive Summary.

Under the above approach, HCAs are given the broad authority to manage UCAs, while being held strictly accountable for the overall results of their efforts. This is consistent with the fundamental principles of the Defense Management Review (DMR).

Draft report Recommendation 1.d. deleted from final report.

1.d. Nonconcur - As noted under 1.b. above, our HCAs are given the broad authority to manage UCAs, while being held strictly accountable for the overall results of their efforts. Consequently, an annual certification by the HCA is neither appropriate nor necessary. The Procurement Management Review (PMR) process is a more suitable method of determining compliance with the restrictions on the award, obligation, and negotiation

Draft report Recommendation 3. deleted from final report.

of UCAs.

Recommendation 2. - Not applicable to the Department of the Navy.

Recommendation 3.

We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition) and the Assistant Secretary of the Navy (Research, Development and Acquisition) report contracting officer noncompliance with Defense Federal Acquisition Regulation Supplement Subpart 217.75 requirements on the award, obligation, and negotiation of undefinitized contractual actions as a material internal control weakness in the annual statement of assurance, and track the status of corrective actions using the procedures established in DoD Directive 5010.38, "Internal Management Control Program," April 14, 1989.

DoN Position:

Concur - This recommendation has been accomplished. UCAs were identified as a material weakness in our fiscal year 1989 Management Control Program. Five corrective actions were identified and completed. No further action is considered necessary in this regard.

DEPUTY COMPTROLLER, DEFENSE LOGISTICS AGENCY COMMENTS

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6100

8 NOV 1991

IN REPLY REFER TO DLA-CI

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE

SUBJECT: Draft Audit Report on Undefinitized Contractual Actions (Project No. OCA-0051)

Enclosed are responses to your draft audit report on Undefinitized Contractual Actions. The attached positions have been approved by Ms Helen T McCoy, Depuuty Comptroller, Defense Logistics Agency

2 Encl

JACQUELINE G BRYANT
Chief, Internal Review Division
Office of Comptroller

TYPE OF REPORT: AUDIT DATE OF APPROVAL: 18 Nov 91

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND #: Undefinitized Contractual Actions (Project No. 0CA-0051)

FINDING: DOD MANAGEMENT OF UNDEFINITIZED CONTRACTUAL ACTIONS (UCA). DoD contracting officers did not properly manage $3.9 billion of UCAs in accordance with U.S.C., Title 10, sec. 2326 and DFARS Subpart 217.75. This condition existed because DoD contracting officers did not fully comply with Defense acquisition regulations covering the award, obligation, and negotiation of UCAs. There also was an absence of adequate internal controls over UCAs As a result, DoD has assumed increased cost risk in the award, obligation, and negotiation process of UCAs. We concluded that for the reviewed unpriced contractual actions, DoD buying activities awarded profits of $51.2 million that exceeded the contractors' justifiable risk.

DLA COMMENTS: Partially concur.

The review of UCAs issued by DLA was limited to three awards made by our Defense Construction Supply Center (DCSC). Considering the negligible utilization of UCAs by this Agency, it was appropriate that the audit of DLA was limited The audit findings are misleading, however, because they are based at least in part on UCAs awarded prior to dissemination to the field level of the statutory requirements. We pointed out this fact to the auditors upon learning, subsequent to the exit conference with DLA, of the specific DCSC awards covered by the audit.

The initial DFARS 217.75 coverage was provided by the Office of the Secretary of Defense (OSD) to the Military Departments and Defense Agencies on 13-14 April 1987 This interim rule was furnished for immediate Departmental implementation applicable to all UCAs "..entered into on or after 16 April 1987, and all solicitations and contracts issued after 16 April 1987 contemplating the use of UCAs." In anticipation of the interim rule requirements, DLA had issued some initial policy guidance to its contracting offices on 20 March 1987 (Contracting Letter 87-16). However, dissemination of the DFARS, issuance of supplemental Defense Logistics Acquisition Regulation (DLAR) guidance, and the subsequent field level dissemination of these and locally developed implementation was not completed until after the three DCSC undefinitized delivery orders covered by this audit had been awarded.

The first of these Basic Ordering Agreement (BOA) orders was awarded 17 April 1987, only three days after the initial DFARS coverage was issued by OSD. Understandably, the BOA terms and conditions had not yet been revised by the Military contracting office that issued the BOA to incorporate the partial pre-definitization obligation limit specified in the new coverage. This same condition existed on the other two orders, which were issued under another BOA that likewise had not yet been updated by the cognizant Military issuing office to include the DFARS requirements. The pre-contract clearance documentation for these other two awards also failed, in the opinion of the auditors, to include additional justification requirements for use of an undefinitized order that was included in the new DFARS coverage.

ENCL 1

The draft report computes profits in excess of the contractor's justifiable risk by $51.2 million on the UCAs covered in the audit, of which $6,942 relates to the three DCSC UCAs. This 'excess' is because there was no indication that a reduced profit rate was deemed appropriate and included in the contracting officer's price definitization negotiation position. In such instances, the auditors used an eight percent rate across-the-board to calculate 'excess profit.'

The auditors presumed that a reduction was not calculated and achieved if it were not addressed in the price negotiation memorandum, which is often not the case. It was also assumed that the eight percent rate was appropriate in every case. Finally, it was assumed that the resulting profit negotiation objective would be achievable in negotiations of each of these sole source UCAs covered by the audit, which is unrealistic. There is ample reason to doubt whether $6,942, or for that matter, any increased costs or profits, were paid to the contractors under these two DCSC undefinitized contractual actions. DLA, therefore, nonconcurs in this audit conclusion.

To summarize, the finding that the awards did not comply with DFARS 217.75 is factually correct but could lead to misunderstandings. Implementation was promptly initiated but takes time. In the interim, it should not be charged that DLA contracting officers failed to comply with regulations they had not received And, DLA contracting officers should not be charged with failure to manage UCA expenditures in the absence of such guidance locally.

Nonconcur as the finding pertains to Defense Contract Management Command. This finding is addressed primarily to DoD buying activities. DCMC is only involved with the negotiation of UCAs when delegated this function by the buying activity The negotiation of the price for an undefinitized contractual action is an area that currently has adequate management controls. Reporting of overage conditions to higher headquarters is a mandatory requirement so that this element can be closely monitored and corrective management attention applied to out of tolerance situations. This is a part of our management reporting process.

Note that the DoD IG report cannot readily be cross-referenced from specific contract numbers applicable to CAOs to findings and recommendations in the report.

In summary, the review of three undefinitized contractual actions awarded by one DLA contracting office during the period does not demonstrate the existence of DLA contracting office or CAO internal control weaknesses. The audit did not demonstrate a compliance failure by DLA personnel subsequent to full field level implementation. Neither does it support the need for the additional guidance addressed in Recommendation 1. And, absent a demonstrated internal control deficiency, no further action is required.

ACTION OFFICER: Mr. Jerry Gilbart, DLA-PPR, 13 Nov 91
PSE REVIEW/APPROVAL: W. FACKENTHALL, CAPT, SC, USN, Deputy Executive Director, Directorate of Contracting, 14 Nov 91

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

TYPE OF REPORT: AUDIT DATE OF POSITION: 18 Nov 91

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND #: Undefinitized Contractual Actions (Project No. 0CA-0051)

RECOMMENDATION 1: We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition), the Assistant Secretary of the Navy (Research, Development and Acquisition), and the Director of the Defense Logistics Agency:

a. Issue guidance to the heads of contracting and contract administration activities to establish procedures requiring compliance with the restrictions on the award, obligation, and negotiation of undefinitized contractual actions as contained in United States Code, Title 10, section 2326, and Defense Federal Acquisition Regulation Supplement Subpart 217.75.

b. Issue guidance on the use of positive and negative incentives for obtaining contractor qualifying proposals in a more timely manner. The guidance should include use of incentives for reducing or suspending progress payments and accelerating definitization of undefinitized contractual actions.

c. Establish written internal control objectives and techniques that cover the award, obligation, and negotiation of undefinitized contractual actions. The guidance should require that:

i. Undefinitized contractual actions be made a separate internal control unit subject to periodic risk assessment reviews, and

ii. Contracting personnel obtain written supervisory approval that the award, obligation, and negotiation of undefinitized contractual actions are in compliance with Defense Federal Acquisition Regulation Supplement Subpart 217 75.

Draft report Recommendation 1.d. deleted from final report.

d. Establish procedures for the heads of the contracting activities to certify annually that undefinitized contractual actions have been properly identified and managed in accordance with the requirements and restrictions contained in United States Code, Title 10, section 2326, and Defense Federal Acquisition Regulation Supplement Subpart 217.75.

DLA COMMENTS: Nonconcur.

This recommendation is primarily addressed to DoD buying activities. However, as addressed in our comments to the audit findings, the minimal findings relative to our contracting offices were on contracts prior to completion, issuance, and implementation of Agency and local policy and procedural guidance And, deficiencies reported relative to CAOs cannot be readily cross-referenced from specific contract numbers to the responsible CAOs and do not demonstrate deficiencies at CAOs managed by DCMC during the period covered by the audit. Finally, there is adequate FAR, DFARS, Agency, and local guidance and internal controls already in place throughout DLA, as discussed in part below. This guidance is made binding on contracting officers by FAR 1.602-1(b) (which obviates the need for the guidance addressed in part a. of Recommendation 1). For these reasons, further DLA policy or internal control procedures are not needed.

ENCL 2

Our DLAR includes DFAR 217.75, the long-standing requirements to (1) limit UCA funding and the Government's predefinitization liability to not more than the amount required up to the milestone date for proposal submission or 25 percent of the total ceiling price, whichever is less, pending receipt of an acceptable definitization price proposal, and (2) for UCAs not involving progress payments, to establish reduced interim billing rates or percentage limitations below the ceiling unit price(s) pending proposal submission and price definitization. These incentives accomplish the objective of the first sentence of part b. of this recommendation.

The intensive management scrutiny called for by DFARS and Agency regulatory guidance includes local oversight by managers and semiannual reports to HQ DLA of all UCA awards and on-hand balances and specific information on any UCAs over 180 days. This resulted in the virtual elimination of UCA awards by DLA. Our UCA awards declined from an FY 1987 level of 564 UCAs totalling $86 million down to 277 UCAs totalling $6 million in FY 1989, $4.7 million of which was for two urgent larger awards. There was no usage of UCAs at some DLA contracting offices and minimal usage at the others. Virtually all of the 275 remaining awards were less than $25,000 and thus exempted by DFARS 217.7502 from the requirements of DFARS Subpart 17.75. Even so, we have extended these rules to all DLA awards and change orders regardless of dollar value, consistent with the intent of the DFARS coverage. With comprehensive coverage in place, further guidance is unnecessary and there are no internal control deficiencies to address at our contracting offices.

Likewise, our Contract Management Directorate already has similar, comprehensive written guidance applicable to DCMC contract administration activities covering letter contracts, unpriced orders placed under basic ordering agreements, unpriced provisional item orders, and unpriced contract modifications. Procedures require monitoring of the definitization schedule by the ACO and the reporting of delays or anticipated delays to the buying office. Control registers are required to be maintained by individual contract to record pertinent data such as due date for receipt of contractor's price proposal, amounts obligated, actions to adjust (increase or decrease) amounts obligated, and schedules for delivery of items.

Our Contract Management Directorate also has written guidance that applies to DCMC CAOs concerning incentives for obtaining contractor qualifying proposals on time. The guidance includes provisions for suspending or reducing progress payments when the contractor fails to submit a required price proposal on time. (Such guidance would have virtually no application at our contracting offices since the remaining UCAs are below $25,000 and timely definitization is not a problem. However, if such guidance is warranted throughout DoD or the Federal Government, it should be standardized in DFARS or FAR.)

DCMC and its CAOs also have adequate management controls to help ensure the timely definitization of undefinitized contractual actions. Also, we note that our Procurement System is certified under E.O. 12352 approximately every three years under the direction of OSD and the Office of Federal Procurement Policy. Therefore, the establishment of separate written internal controls and certifications at the Headquarters level are not needed.

DISPOSITION:
( ) Action is ongoing. Estimated Completion Date
(X) Action is considered complete.

ACTION OFFICER: Mr. Jerry Gilbart, DLA-PPR, 13 Nov 91
PSE REVIEW/APPROVAL: W. FACKENTHALL, CAPT, SC, USN, Deputy Executive Director, Directorate of Contracting, 14 Nov 91

DLA APPROVAL: Helen T. McCoy, Deputy Comptroller

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