

August 30, 2004



# Acquisition

## Undefinitized Contractual Actions (D-2004-112)

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### **Acronyms**

DCADS	Defense Contract Action Data System
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
PNM	Price Negotiation Memorandum
UCA	Unfinalized Contractual Action



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
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August 30, 2004

MEMORANDUM FOR AUDITOR GENERAL, DEPARTMENT OF THE ARMY  
NAVAL INSPECTOR GENERAL  
ASSISTANT SECRETARY OF THE AIR FORCE  
(FINANCIAL MANAGEMENT AND COMPTRROLLER)

SUBJECT: Report on Undefined Contractual Actions (Report No. D-2004-112)

We are providing this report for review and comment. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. We request that the Army reconsider its position on each of the recommendations and provide comments on the final report. Also, we request that the Navy comment on each audit recommendation in the final report. The Air Force comments were partially responsive. We request that the Air Force provide additional comments to Recommendations 1., 2., and 3. We request additional comments from each of the Service Acquisition Executives by October 14, 2004.

If possible, please send management comments in electronic format (Adobe Acrobat file only) to [Audcm@dodig.osd.mil](mailto:Audcm@dodig.osd.mil). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the /Signed/ symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be send over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Eric B. Edwards at (703) 604-9219 (DSN 664-9219) or Mr. Terry L. McKinney at (703) 604-9288 (DSN 664-9288). See Appendix E for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

*David K. Steensma*

David K. Steensma  
Assistant Inspector General  
for Contract Management

# Office of the Inspector General of the Department of Defense

**Report No. D-2004-112**  
(Project No. D2003CF-0072)

**August 30, 2004**

## Unfinitized Contractual Actions

### Executive Summary

**Who Should Read This Report and Why?** This report should be read by acquisition and contracting officials who issue unfinitized contractual actions (letter contracts). This report discusses the need to improve the management of letter contracts.

**Background.** Public Law 99-591, "Continuing Appropriations for Fiscal Year 1987," section 908(b), requires the Office of the Inspector General of the Department of Defense to periodically conduct an audit of unfinitized contractual actions and submit a report to Congress on the management and value of UCAs for each Military Department. The last audit issued by the Inspector General of the Department of Defense (IG DoD) on unfinitized contractual actions was IG DoD Report No. 97-204, "Unfinitized Contractual Actions," August 15, 1997. Unfinitized contractual actions are contractual actions, issued as letter contracts and other instruments, for which the contract terms, specifications, or prices are not agreed to before performance begins. Unfinitized contractual actions are restricted for use to meet an urgent requirement of an agency and for use only after a decision is made that no other alternative contracting method will fulfill the urgent need. According to Defense Contract Action Data System, DoD issued 1,453 letter contracts, valued at \$12.5 billion, from FY 1998 through FY 2002 that were subject to Public Law 99-591. We reviewed 72 of the 1,453 letter contracts, valued at \$1.7 billion, that were issued by activities within the Military Departments.

**Results.** The Military Departments implemented performance management systems to increase awareness of the status of unfinitized contractual actions. However, for seven contracting activities, the Military Departments compliance with statutory provisions pertaining to unfinitized contractual actions needed improvement. For 72 letter contracts reviewed, contracting officials did not adequately:

- justify the issuance of 10 (14 percent) of the letter contracts valued at over \$385 million;
- definitize 39\* (54 percent) of the letter contracts reviewed, valued at \$1.3 billion, within the required 180 day timeframe; and
- document the reasonableness of negotiated profit rates for 60 (83 percent) of the letter contracts required to contain the allowable profit, valued at \$1.4 billion.

Management control programs lacked coverage of unfinitized contractual actions to ensure that unfinitized contractual actions were in compliance with DoD regulations. As a result, unfinitized contractual actions may have been used when they were not

\*Eight required more than one year.

warranted. The Government risk increases when contracts are not definitized within required timeframes. Furthermore, the omission of reporting the allowable profit during negotiations of the undefinitized contractual actions may result in excess profits for contractors.

To preclude these problems in the future, the Service Acquisition Executives should develop implementing instructions to be followed when the use of an undefinitized contract action is being considered. Specifically, the Service Acquisition Executives should provide guidance to assess the adverse impact that will result if a contracting method other than an undefinitized contractual action is used. In addition, reasons for untimely definitization of letter contracts and schedule extensions should be documented in the contract file and instructions should be developed for determining the allowable profit when the contracts are being definitized. See the Finding section of the report for the detailed recommendations.

**Management Comments and Audit Response.** The Deputy Assistant Secretary of the Army (Policy and Procurement) generally nonconcurred with the recommendations stating that sufficient guidance already exists. We disagree with the Army comments because the need for additional guidance was apparent from the problems identified at field activities. The Chief of Staff/Policy for the Deputy Assistant Secretary of the Navy (Acquisition) suggested that the recommendations would be more appropriately directed to the Under Secretary of Defense (Acquisition, Technology, and Logistics). The Navy believes that the recommendations are uniformly applicable for processing undefinitized contractual actions by all Defense department contracting activities. We believe that each Service is unique and should tailor its guidance to its own management style. The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred with all the recommendations. However, the Air Force needs to clarify its planned actions to reemphasize the UCA requirements for justifying letter contracts. We request management comments from the Army, the Navy, and the Air Force on the final report by October 14, 2004. See the Finding section for a discussion of management comments and the Management Comments section for the complete text of the comments.

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## Background

Undefinitized contractual actions (UCAs) are contractual actions for which the contract terms, specifications, or prices are not agreed to before performance begins. Undefinitized contractual actions are generally letter contracts. A letter contract is a binding agreement that authorizes the contractor to begin performing services or manufacturing supplies immediately. Such work is started under a letter contract before the risk or cost of the project is known. We used information provided by the Defense Contract Action Data System (DCADS) to conduct this audit. DCADS identified only letter contracts, therefore, our review focused solely on letter contracts because we could not identify unpriced orders or unpriced provisioned item orders.

United States Code, title 10, section 2326 (10 U.S.C. 2326), “Undefinitized Contractual Actions: Restrictions,” restricts the use of UCAs to an urgent requirement of an agency and establishes limitations on the obligation of funds, the definitization of terms, and allowable profit for UCAs. The Government limits the use of UCAs because these contracts place the Government at a distinct disadvantage in negotiating final prices.

Undefinitized contractual actions for foreign military sales, purchases that do not exceed the simplified acquisition threshold, special access programs, and congressionally mandated long-lead procurement contracts are not subject to compliance with 10 U.S.C. 2326. The Defense Federal Acquisition Regulation Supplement (DFARS) 217.7402, titled “Exceptions,” stipulates that contracting officers should apply DFARS 217.74 on congressionally mandated long-lead procurement contracts to the maximum extent practicable.

**Congressional Mandated Review.** Congressional concerns resulted in establishing the codification of restrictions on the use of UCAs in 10 U.S.C. 2326 and language in Public Law 99-591, “Continuing Appropriations for Fiscal Year 1987,” section 908(b), which states:

Oversight by Inspector General – The Inspector General of the Department of Defense shall:

- (1) periodically conduct an audit of contractual actions under the jurisdiction of the Secretary of Defense (with respect to the Defense Logistics Agency) and the Secretaries of the military departments; and
- (2) after each audit, submit to Congress a report on the management of undefinitized contractual actions by each Secretary, including the amount of contractual actions under the jurisdiction of each Secretary that is represented by undefinitized contractual actions.

The IG DoD Report No. 97-204, “Undefinitized Contractual Actions,” on August 15, 1997, was our last audit of undefinitized contractual actions.

**DoD Reported Letter Contracts.** The Defense Contract Action Data System reported that DoD issued 5,758 letter contractual actions valued at \$28.7 billion from FY 1998 through FY 2002. After eliminating contracts exempt from the public law and contract modifications, a universe of 1,453 letter contracts valued at \$12.5 billion remained. According to DCADS, DoD definitized 822 letter contractual actions valued at \$7.8 billion from FY 1998 through FY 2002. When a letter contract is issued, the funds obligated shall not exceed 50 percent of the contract ceiling price. When a letter contract is definitized additional obligations are used to fund the negotiated contract price. Differences will exist between the dollar values for letter contracts issued and definitized letter contracts because contract award is based on an estimate and the definitization dollar value is based on negotiations.

Table 1 shows the number of letter contracts issued and definitized and the amounts obligated by DoD from FY 1998 through FY 2002 as recorded in DCADS. See Appendix B for more details on the amount of undefinitized contract actions under the jurisdiction of each Secretary of the Military Departments and the Directors of the Defense agencies.

<u>Fiscal Year</u>	<u>Issued</u>		<u>Definitized</u>	
	<u>Number</u>	<u>Amount Obligated</u>	<u>Number</u>	<u>Amount Obligated</u>
1998	315	\$1,457,153,187	48	\$ 106,321,956
1999	296	3,611,200,031	114	438,280,607
2000	237	3,669,813,218	216	1,167,021,156
2001	270	2,183,529,952	219	2,630,074,140
2002	335	1,578,099,041	225	3,476,055,683
<b>Total</b>	<b>1,453</b>	<b>\$12,499,795,429</b>	<b>822</b>	<b>\$7,817,753,542</b>

The number and value of letter contracts issued by DoD fluctuated from 315 in FY 1998, valued at \$1.46 billion, to 335 in FY 2002, valued at \$1.58 billion. The number of letter contracts definitized significantly increased from 48 in FY 1998, valued at \$106.3 million, to 225 in FY 2002, valued at \$3.48 billion.

## **Statutory and Regulatory Requirements**

**Approval to Use UCAs.** Section 2326(a) of 10 U.S.C. states:

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

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incurred for purposes of determining terms, specifications, and price before performance is begun under the contract action.

FAR Part 16.603, "Letter Contracts," is defined as a written preliminary contractual instrument that authorizes the contractor to begin immediately manufacturing supplies or performing services. FAR Part 16.603-3 provides that a letter contract may be used only after the head of the contracting activity or a designee determines in writing that no other contracting method is suitable.

DFARS 217.7404-1, "Authorization," requires that the contracting officer obtain approval from the head of the contracting activity before entering into a UCA and also requires that the contracting officer request for UCA approval must include a full explanation of the need to begin contract performance before contract definitization.

**Contract Definitization.** FAR Part 16.603-2(c), concerning letter contracts, provides that FAR clause 52.216-25, titled "Contract Definitization," shall be followed and a definitization schedule will be required to include a target date for definitization, which shall be the earliest practicable date for definitization. The schedule will provide for definitization of the contract within 180 days after the date of the letter contract or before completion of 40 percent of the work to be performed, whichever occurs first. However, the contracting officer may, in extreme cases and according to agency procedures, authorize an additional period.

DFARS 217.7403, "Policy," states that UCAs shall only be used when contracting officials cannot negotiate definitized contracts in sufficient time to meet the requirements of the Government. Defense Federal Acquisition Regulation Supplement 217.7404-3, states:

UCAs shall contain definitization schedules that provide for definitization by the earlier of:

- (1) the date that is 180 days after issuance of the action (this date may be extended but may not exceed the date that is 180 days after the contractor submits a qualifying proposal), or
- (2) the date on which the amount of funds obligated under the contract action is equal to more than 50 percent of the not-to-exceed price.

DFARS 217.7404-3(b) further states that the contractor proposal submitted in accordance with the definitization schedule is a material element of the contract, and if the contractor does not submit a timely qualifying proposal, the contracting officer may suspend or reduce progress payments or take appropriate action.

Section 2326(g)(2) of 10 U.S.C. defines a "qualifying proposal" as:

. . . 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.

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**Allowable Profit.** Section 2326(e) of 10 U.S.C. and DFARS 217.7404-6, “Allowable Profit,” require that:

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.

DFARS 215.404-4(c)(2), “Contracting Officer Responsibilities,” states that the contracting officer must use a “weighted guideline” for determining profit or fee objectives unless a modified “weighted guideline” applies or an alternate approach is justified. A weighted guideline is a method used by DoD contracting officers to establish a basic profit rate under a formula that focuses on profit factors such as performance risk and contract type risk.

DFARS 215.404-71-3(d)(2) states that contracting officers shall assess the amount of contractor-incurred costs prior to definitization, before assigning the cost-risk element (contract-type risk) of the profit objective. DFARS 215.404-71-3(d)(2) also states that when costs have been incurred prior to contract definitization, contracting officers should generally regard the contract-type risk to be in the low end of the designated risk range. A contracting officer may assign a value as low as zero percent for contract-type risk when a substantial portion of the cost has been incurred prior to definitization.

**Contract Documentation.** FAR 15.406-3(10), states the contracting officer must document in the contract file the basis for the profit or fee prenegotiation objective and the profit or fee negotiated. The documentation will be represented in a price negotiation memorandum or similar contracting instrument. DFARS 215.404-4 requires the profit analysis to be documented in the contract file.

## Objectives

The audit objective was to evaluate DoD compliance with restrictions on undefinitized contractual actions imposed by 10 U.S.C. 2326. We also reviewed the management control program related to the overall audit objective. See Appendix A for a discussion of the scope and methodology and the review of the management control program.

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## Management of Letter Contracts

Military Department contracting activities were not consistently complying with statutory provisions applicable to undefinitized contractual actions (UCAs), also known as letter contracts. For 72 letter contracts, valued at \$1.7 billion, contracting officials at 7 activities did not adequately:

- justify the issuance of 10 (14 percent)\* of the letter contracts reviewed, valued at \$385 million;
- definitize 39 (54 percent)\* of the letter contracts reviewed, valued at \$1.3 billion, within the 180 day timeframes; and
- document the reasonableness of negotiated profit rates for 60 (83 percent)\* of the letter contracts required to contain the allowable profit, valued at \$1.4 billion.

Inadequate justification for the letter contracts occurred because contracting officials either did not adequately document the adverse impact or maintain a record of the adverse impact in the contract files. Contract definitization delays generally occurred because the Military Departments and the contractor were working to reach agreement on contractual terms, conditions, and price, but no explanations were included in the contract file for expected late definitizations and schedule extensions. Furthermore, contracting officers were either unaware of the requirement or unsure how to implement the existing requirement for computing the allowable profit and therefore failed to do so. As a result, the Military Department's position in the price negotiation and contract award may have been weakened and delays definitizing contracts may have increased the risk to the Government. Furthermore, the failure to adequately document allowable profit may have resulted in excess profits.

### Letter Contracts Reviewed

We judgmentally selected and reviewed 72 undefinitized contractual actions. The contracts were reported as letter contracts in the Defense Contract Action Data System. These contracts were valued at \$1.7 billion, and were either issued or definitized from FY 1998 through FY 2002. We visited seven Army, Navy, and Air Force contracting organizations that initiated the 72 UCAs that we reviewed. The UCAs were issued for the acquisition of capital assets and services. See Appendix C for details on the contracting organizations we visited, value of the letter contracts by activity, and a summary of the deficiencies noted.

\*Judgment sample percentage does not generalize to universe.

## Contract Deficiencies

Our review of the 72 UCAs identified a total of 109 deficiencies. Each of the 72 UCAs had at least one deficiency. The deficiencies consisted of three different types: incomplete justifications issued, untimely definitization, and insufficient documentation supporting the negotiated allowable profit rate. See the following table for details relating to each Military Department.

<u>Deficiency</u>	<u>Army</u>	<u>Navy</u>	<u>Air Force</u>	<u>Total</u>
Issuance Without Adequate Justification	3	4	3	10
Untimely or No Contract Definitization	20	14	5	39
Insufficient Justification for Negotiated Profit Rate	26	13	21	<u>60</u>
Total				109

See Appendix D for further details of the deficiencies.

**Justification.** Approval documents for 10 (14 percent)\* of 72 letter contracts reviewed, valued at over \$385 million, did not adequately describe the adverse impact if work was delayed until contractual terms, specifications, and prices were finalized. The contract files did not have adequate documentation to support the reason a letter contract was necessary or preferred over routine contracting procedures. Also, 18 (25 percent) of the 72 letter contracts reviewed were issued when the acquisition requirements had been known by the agency prior to the issuance of the letter contracts.

**Adverse Impact Not Disclosed.** Of the 10 UCAs, 6 (2 Army and 4 Navy) contracts, representing 8 percent\* of the total letter contracts reviewed, did not contain the adverse impact on agency requirements resulting from delays in beginning performance if a UCA was not issued. The adverse impact is the basis supporting the issuance of a letter contract versus using routine contracting procedures. The contracting officers either did not perform an adverse impact analysis or document the effect of the adverse impact on the agency requirements. Although the adverse impact was not documented, senior contracting officials at the various activities had approved the use of letter contracts.

**Adverse Impact Lacks Specifics.** Of the 10 UCAs, 4 (1 Army and 3 Air Force) representing 6 percent\* of the total letter contracts reviewed, lacked specifics and contained vague statements describing the adverse impact on agency requirements resulting in inconclusive support for the issuance of letter contracts. For example, for Aeronautical Systems Center letter contract F33657-00-C-2120, dated June 12, 2000, for test program sets, the approval document states without issuance of an undefinitized contract action, the Milestone III production decision will not be achievable and fielding of the Follow-On Test Program Sets will not

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be timely for the user. The approval document did not describe the specific impact on the agency requirements if routine contracting procedures were used.

For letter contracts for which the issuing contracting official was available, we found that the lack of specifics for adverse impact existed because the contracting officials believed they had met the regulatory requirement even though they had not adequately addressed the adverse impact. For letter contracts for which the contracting official was not available, we did not identify a documented adverse impact in the contract files. Accordingly, we believe guidance in the form of an implementing instruction is required to set forth what is anticipated and what constitutes an impact. For example, a monetary resource impact when cited should be quantified and reported to support the use of a letter contract versus a routine contract method. Also, more emphasis is required to mandate improved letter contract justification documentation.

**Letter Contracts Issued for Known Acquisition Requirements.**

Contracting officers issued 18 of the 72 letter contracts, valued at \$731 million, for known acquisition requirements. These contracts were used for such actions as replacing an existing contract which was expiring in order to prevent a break in contractor's production and to establish a service life assessment program. For example, the Aeronautical Systems Center contract F33657-01-C-4600, for the Global Hawk engineering and manufacturing development effort, was originally scheduled for an award date of November 30, 2000. The letter contract was required to avoid a significant negative impact on the delivery schedule which would impact production efforts for the low rate initial production and full rate production. The system was an existing known requirement prior to the letter contract issuance. The contract file documentation did not disclose whether the contracting officer conducted deliberation of alternative contracting methods and the corresponding impact.

The adverse impact for a known requirement is diminished when the letter contract is issued a significant amount of time after the urgency is established. For example, Army Communications and Electronic Command contract DAAB07-01-C-L304 was issued March 16, 2001. The statement of urgency was issued for an aircraft replacement to support SOUTHCOM counternarcotics missions in July 1999—20 months later. The time lapse diminished the actual urgency and adverse impact reported earlier. A Request for Approval of Determination and Findings, dated March 14, 2001, stated the letter contract must be approved on or before March 16, 2001, in order to meet schedule requirements and preclude a loss of funding. A Determinations and Finding was subsequently issued March 16, 2001, that did not contain reference to the loss of funding but reported the need for the letter contract to meet the production schedule. A lack of consistent reporting existed for the basis to support the UCA approval. We believe a letter contract should not have been issued given the significant amount of time between the stated urgency and letter contract issuance. In the instances of letter contracts issued for known requirements, the contract price can be reasonably estimated because the contract requirements, terms, and specifications are known. Appendix C provides details on the letter contracts with justification deficiencies.

**Untimely Definitization.** Contracting officers did not definitize the terms and prices for 39 (54 percent)\* of 72 letter contracts within the specified timeframes. Of the 39 letter contracts, 35 contracts were definitized beyond 180 days and 4 contracts had not been definitized at the time of the audit fieldwork. The contract terms and prices of letter contracts are required to be definitized within 180 days from the issuance date. Table 3 shows days elapsed before the 35 letter contracts were definitized.

	Letter Contracts	Days to Definitize				
		181-360	361-499	500-699	700-899	900+
Army	19	15	3	1	0	0
Navy	12	8	1	2	0	1
Air Force	4	4	0	0	0	0
Total	35	27	4	3	0	1

For the 72 letter contracts reviewed:

- 28 (39 percent)\* of the letter contracts reviewed were definitized within 180 day period,
- 35 (49 percent)\* of the letter contracts reviewed were definitized an average of 322 days after the contracts were awarded, and
- 4 (6 percent)\* of the letter contracts reviewed were not definitized at the completion of our audit field work.

For example, CECOM contract DAAB07-00-C-L004, issued December 22, 1999, for procurement of initial spares for a Common Ground Station took 555 days to definitize from the issuance date. The contract was originally planned for definitization on April 20, 2000, 119 days after issuance. However, the proposal for definitization was not submitted until June 28, 2000—9 days after the initial 180 day timeframe allowed to definitize the contract. The definitization did not occur for another 366 days, or on June 29, 2001, from the date the proposal was received. According to a contracting official, proposal updates requiring numerous adjustments caused the definitization delay. The planned definitization schedule established was unrealistic.

Twelve proposals were submitted within the initial scheduled requirement of 180 days but were definitized more than 180 days from the date of their submittal. None of the files for the 12 contracts contained schedule extension approvals or explanations in the contract file as to why the 180 day timeframe was exceeded. Furthermore, contracting officers took no steps to suspend or reduce payments related to these letter contracts that were not timely definitized.

**Waivers.** The Air Force waived definitization schedule limitation in DFARS 217.7404-3, based on Air Force Deputy Assistant Secretary (Contracting) memo, titled “Undefinitized Contract Actions and Contingency Operations in Support of Operations Enduring Freedom and Noble Eagle,” dated

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November 28, 2001. DFARS 217.7404-5, titled “Exceptions,” states that the head of an agency may waive the limitation in DFARS 217.7404-3 for UCAs if a waiver is determined to be needed to support a contingency operation. The 10 U.S.C. 101(a)(13) defines a contingency operation as a military operation that is designated by the Secretary of Defense as an operation in which members of the armed forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force. As a result of the criteria described above, we accept the Air Force treatment of 5 letter contracts cited for untimely definitization.

**Risk of Delayed Contract Definitizations.** Untimely definitization of contracts transfers additional cost and performance risk from the contractors to the Government. The Military Departments normally reimburse contractors for all allowable costs they incur on letter contracts. Therefore, contractors have less cost risk in performing the contractual efforts when definitization is untimely, particularly if a fixed-price contract is contemplated for the procurement. A fixed-price contract places the greatest amount of risk on the contractor for meeting cost, schedule, and performance goals.

**Allowable Profit Determination.** The allowable profit was not documented for 60 of 72 letter contracts, representing 83 percent\* of letter contracts required to comply with DFARS 217.7404, that were definitized for a total value of \$1.4 billion. The letter contract definitization contracts did not contain evidence in the price negotiation memorandum or the weighted guidelines that allowable profit factors, such as the reduced cost risk, were considered prior to negotiation of the final price. Also, the cost incurred during the contract performance was not evident in the contract reviews of profit determinations which effect the development of the cost risk factor. Without sufficient information to support the allowable profit, we cannot determine whether contracting officers applied or even considered allowable profit in definitizing the undefinitized contractual actions to comply with DFARS 217.7404.

**Price Negotiation Memorandums.** The price negotiation memorandums or business clearance memorandums reviewed did not contain the profit analysis for determining the allowable profit in accordance with DFARS 217.7404. For example, the contracting officer, for the Naval Air Systems Command contract number N00019-00-C-0249, was familiar with the DFARS requirement on allowable profit and considered cost incurred but did not document the method to compute the allowable profit in the price negotiation memorandum or the weighted guidelines. Naval Air Systems Command internal business clearance policy did not address a documentation requirement to provide an explanation on how the DFARS allowable profit computation is determined. As a result, no determination can be made whether the cost incurred was considered for both the period prior to definitization and for the remaining work effort in computing the allowable profit.

**Weighted Guidelines.** Weighted guidelines are used to compute profit on contracts to be definitized. Of 30 contracts with completed weighted guidelines, no reference was made for computing the allowable profit when negotiating the

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definitization of the UCA. The weighted guidelines did not disclose evidence that the allowable profit factors were considered in definitization of letter contracts to comply with DFARS 217.7404.

**Contracting Officer Positions.** Consideration of allowable profit ensures that the Government does not negotiate a profit rate that exceeds the proportion of work remaining on the contract. On some contracts, contracting officers stated they considered the allowable profit methodology; however, no documentation was available to support their assertion in the contract files. Furthermore, contracting officials were not definite on the method to implement existing guidance on computing the allowable profit.

**Advanced Procurement Contracts.** During our review, we found 15 advance procurement actions identified as letter contracts that were excluded from our reporting because advance procurement contracts are not required to comply with 10 U.S.C. 2326, but are recommended to follow the guidelines.

## Reasons for Deficiencies Identified

The lack of required and sufficient adverse impact justifications in the letter contracts reviewed was because contracting officials either did not adequately document the adverse impact or in instances where the contracting official was no longer available, a written adverse impact was not in the contract file. The lack of timely definitization occurred because the Military Departments and the contractor were working to reach an agreement on contract terms and prices but did not include explanations in the contract file for the anticipated late definitization and the schedule extensions that occurred. Contracting officials did not report the allowable profit because they either were not aware of the requirement, did not know how to implement the policy, or just failed to document their actions.

## Conclusion

The absence of an adverse impact in contracts impairs the ability to support the justification for the award of UCAs. The untimely definitization of letter contracts lacked explanations in the contract files to support schedule extensions. The failure to adhere to policies on UCAs weakened the contractual position of the Military Departments in the award and negotiation process. Without documenting the basis for the allowable profit, the contracting organizations of the Military Departments may have enabled the contractors to obtain excessive profits.

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## Recommendations, Management Comments, and Audit Response

We recommend that the Assistant Secretary of the Army (Acquisition, Logistics, and Technology), Assistant Secretary of the Navy (Research, Development, and Acquisition), and Assistant Secretary of the Air Force (Acquisition) take action for processing UCAs for their contracting organizations. The Army generally nonconcurred with most of the recommendations. The Navy did not address the recommendations. Instead, the Navy requested that the recommendations be redirected to the Under Secretary of Defense (Acquisition, Technology, and Logistics) for response. The Air Force generally concurred, however, we found some of its comments to be nonresponsive. Our response to each Services' management comments is addressed below.

**Navy Management Comments.** The Chief of Staff/Policy for the Deputy Assistant Secretary of the Navy (Acquisition) stated that the recommendations should be addressed to the Under Secretary of Defense (Acquisition, Technology, and Logistics) because UCA processing is required by all Defense department contracting activities.

**Audit Response.** The Navy deferral of its comments on the recommendations to the Under Secretary of Defense (Acquisition, Technology, and Logistics) was not responsive. The Navy should tailor existing UCA policy that is used by its acquisition activities. The Naval Sea Systems Command and the Naval Air Systems Command have UCA guidance that could be strengthened for processing UCAs to ensure letter contracts are awarded with sound support. The recommendations will increase the management controls over developing, processing, and tracking undefinitized contractual actions. Therefore, we request that the Navy reconsider its position and provide comments to the final report.

**1. Prepare specific instructions, for use by the field activities when issuing letter contracts for the procurement of goods and services, outlining the requirement to assess the adverse impact to support issuance of a letter contract.**

**Army Management Comments.** The Deputy Assistant Secretary of the Army (Policy and Procurement) nonconcurred and stated the requirement to assess the adverse impact to support the issuance of a letter contract was already provided for in DFARS 217.7404-1(a).

**Audit Response.** The Army management comments were nonresponsive. We found instances where the written adverse impact was broad and general, and therefore, limited the ability to make the best informed decision for awarding a UCA. Although DFARS 217.7404-1(a) requires reporting an adverse impact, the regulation does not provide a description on type of impacts. Based on our review, we support the reinforcement of the DFARS requirement and the establishment of distinct, measurable reporting requirements that will provide for definitive adverse impact reporting. We request that the Army reconsider its position on the recommendation and provide comments on the final report.

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**Air Force Management Comments.** The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred and stated that the Policy Chiefs will reemphasize the requirement to fully explain the adverse impact on the agency resulting from delays in beginning performance.

**Audit Response.** Although the Air Force concurred, its management comments were only partially responsive. The Air Force only partially meets the full intent of our recommendation. Written instructions tailored to require a measurable adverse impact would enhance the ability to determine the actual effect on agency requirements. The development of an instruction requiring a measurable monetary or quantifiable adverse impact will provide an enhanced adverse impact assessment for approving a UCA. We request that the Air Force reconsider its position on the recommendation and provide comments on the final report.

**2. Require contracting officers to document the adverse impact in the contract file if the procurement is delayed.**

**Army Management Comments.** The Deputy Assistant Secretary of the Army (Policy and Procurement) nonconcurred and stated that the requirement for the contracting officer to assess the adverse impact to support issuing a letter contract was already provided for in DFARS 217.7404-1(a).

**Audit Response.** The Army management comments were nonresponsive. We agree that the requirement exists in the DFARS. However, adverse impacts were not always documented in the contract file or were not specific, even though DFARS 217.7401-1(a) requires the contracting officer to fully explain the adverse impact on agency requirements resulting from delays in beginning performance. Therefore, reemphasis is needed to address the requirement. We request that the Army reconsider its position on the recommendation and provide comments on the final report.

**Air Force Management Comments.** The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred and stated that the Air Force Material Command will include this topic in the July 4, 2004, Policy Chiefs video teleconference.

**Audit Response.** The Air Force comments were partially responsive. Although the Air Force concurred and stated that Air Force Material Command will include the topic in a Policy Chiefs video teleconference, we believe additional emphasis in the form of a memorandum to contracting activities should be undertaken to ensure adverse impacts are documented in the contract file. Therefore, we request that the Air Force reconsider its position on the recommendation and provide comments on the final report.

**3. Require justification documents for all letter contracts that provide specific details on the procurement planning performed.**

**Army Management Comments.** The Deputy Assistant Secretary of the Army (Policy and Procurement) nonconcurred and responded that DFARS 217.7404-1(a) already states that the contracting officer's request for approval for

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entering into a UCA must fully explain the need to begin performance before definitization.

**Audit Response.** The Army management comments are nonresponsive. The policy does not address prior planning but rather explains the need to begin performance before definitization. The DFARS 217.7404-1(a) does not translate into a requirement to document earlier planning to award a contract. Documenting the acquisition history will at a minimum, provide an understanding of events that lead up to the UCA and potentially identify the root cause for the undefinitized contractual action. We request that the Army reconsider its position on the recommendation and provide comments on the final report.

**Air Force Management Comments.** The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred and stated procurement planning is part of justification for a letter contract and Air Force Material Command will discuss this subject during a Policy Chiefs video teleconference.

**Audit Comments.** The Air Force comments are partially responsive. The justification for a letter contract explains the urgency that contributes to the need for the UCA but not the prior planning that existed for the contractual effort before the urgency developed to pursue a letter contract. The prior procurement planning would serve to identify the chronology of events that lead up to the urgency for a UCA and potentially identify the root cause for a letter contract that is not always evident from the justification documents. We request that the Air Force reconsider its position on the recommendation and provide comments on the final report.

#### **4. Require contracting officers to provide written justification in the contract files for surpassing DFARS definitization schedule milestones.**

**Army Management Comments.** The Deputy Assistant Secretary of the Army (Policy and Procurement) partially concurred and will reiterate the statutory requirements relative to the definitization of UCAs and the importance of documenting the circumstances affecting the definitization schedule. However, DFARS 217.7404-3 did not specifically address the scope of contract file data for instances exceeding the 180 day definitization schedule.

**Audit Response.** The Army comments were nonresponsive. FAR Part 4.801 requires that documentation in the contract files be sufficient to constitute a complete history of the transaction for the purpose of supporting actions taken and providing a complete background as a basis for informed decisions at each step in the acquisition process. The regulation further provides that the head of each office performing contracting shall establish files containing the records of all contractual actions. These records will include information to be used for reviews. Because DFARS 217.7404-3 includes specific information relating to definitization schedule extensions, the corresponding authorization should be documented to facilitate an understanding of the actions during an external review. We request that the Army reconsider its position on the recommendation and provide comments on the final report.

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**Air Force Management Comments.** The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred and stated instead of just requiring written contracting officer justification, management reporting will be strengthened for late definitizations. The Air Force intends to change the Air Force Federal Acquisition Regulation Supplement reporting requirement to match the DFARS requirement of 180 days and will revise the former by September 30, 2004.

**5. Develop implementing guidance on the allowable profit requirement as defined in DFARS 217.7404-6, “Allowable Profit.”**

**Army Management Comments.** The Deputy Assistant Secretary of the Army (Policy and Procurement) nonconcurred and responded that DFARS 217.7404-6 guidance addresses the allowable profit computation elements. Further, this report does not quantify whether a substantial portion of the required performance has been completed for the contracts at issue.

**Audit Response.** The Army comments were nonresponsive. The predominant number of contracts reviewed lacked information that distinguished the allowable profit calculation required on a UCA from any other type of contract. The documentation did not contain clear and concise information to demonstrate cost incurred, cost risk, and the amount of performance completed for specifically computing the allowable profit for a UCA. The contract file documentation reviewed failed to distinguish the profit calculation in support of definitizing an undefinitized contractual action from any other type of contract. The inability to distinguish the profit computation for an allowable profit, as required by DFARS 217.7404-6, justifies implementing guidance to ensure the criteria is met. We request that the Army reconsider its position on the recommendation and provide additional comments on the final report.

**Air Force Management Comments.** The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred and agreed guidance needs improvement. The Air Force Material Command future training will emphasize the need for contracting officers to document the basis of the allowable profit determination and reasonableness of the negotiated profit rates on letter contracts in the price negotiation memorandum. Furthermore, the Air Force weighted guidelines tool will be revised to include a breakout of UCAs under contract type. This will allow the contracting officer the ability to adjust the profit/fee for lower risk due to actuals incurred.

**6. Require contracting officers to document the basis for the allowable profit determination on letter contracts in the price negotiation memorandum.**

**Army Management Comments.** The Deputy Assistant Secretary of the Army (Policy and Procurement) nonconcurred with the requirement for the contracting officers to document the basis for the allowable profit determination on letter contracts in the price negotiation memorandum.

**Audit Response.** The Army comments were nonresponsive. The price negotiation memorandums and corresponding weighted guidelines lacked the methodology or explanation on how DFARS 217-7404-6 was implemented to

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satisfy computing the allowable profit for an undefinitized contractual action. In instances for which profit calculation existed, there was no indication that the profit was computed specifically for a UCA versus another type of contract. We request that the Army reconsider its position on the recommendation and provide comments on the final report.

**Air Force Management Comments.** The Associate Deputy Assistant Secretary of the Air Force (Contracting) concurred and agreed that better documentation is required. The Air Force Material Command will reinforce the requirement in contract pricing training classes and upcoming contract pricing training modules. Further, documentation required will be reinforced with the training.

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## Appendix A. Scope and Methodology

**Universe and Sample Information.** We used DCADS to identify a universe and sample of UCAs for review. As discussed in the Finding, DCADS identified only letter contracts. We selected a sample of 87 letter contracts, valued at \$2.9 billion, consisting of low, medium, and high dollar contracts issued by seven Army, Navy, and Air Force contracting organizations. The Army activities visited were the U.S. Army Communications-Electronics Command, U.S. Army Aviation and Missile Command, and the Defense Contracting Command–Washington. The Navy activities visited were the Naval Sea Systems Command and the Naval Air Systems Command. The Air Force activities visited were the U.S. Air Force Aeronautical Systems Center and the U.S. Air Force Oklahoma Air Logistics Command. We judgmentally selected the letter contracts reviewed from a universe of 1,453 letter contracts with obligations totaling \$12.5 billion. The actions were recorded in DCADS from FY 1998 through FY 2002. All the letter contracts reviewed were issued by the Military Departments.

Because of the incomplete information on UCAs and errors in the DCADS data, we were unable to project DoD-wide audit results. Therefore, the audit results presented in this report are the analysis of attributes based only on the 72 letter contracts reviewed. Because unpriced orders under basic ordering agreements and provisioned item orders were not included in DCADS, we did not include them in our judgmental sample selection. However, we did inquire on their capture in the UCA reporting systems at field sites visited. Also, we did not include the results of advance procurement contracts in our letter contract reporting. Advance procurement contracts are not required to comply with 10 U.S.C. 2326 although they are to follow criteria to the maximum extent possible. The details are summarized in Appendix D.

**Use of Computer-Processed Data.** We relied on computer-processed data from DCADS to determine the contracting organizations to visit and to perform the audit sample selection. Although we did not perform a formal reliability assessment of the computer-processed data, we verified the DCADS contractual categorization and dollar value against official records at visited field activities.

**Review of Documentation and Interviews.** We reviewed documentation maintained by the contracting organizations of the Military Departments to support letter contracts awarded or definitized from FY 1998 through the FY 2002. The types of contract file documentation examined were:

- award justification and approval documentation,
- acquisition plans,
- appropriation data sheets (obligation documents),
- contract modifications,
- price negotiation memorandums,

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- business clearance memorandums,
  - Defense Contract Audit Agency audit reports,
  - price or cost analysis reports,
  - reports generated from DCADS, and
  - profit determinations.

We interviewed contracting officers and procurement officials covering award and definitization of letter contracts and related management control programs.

We performed this audit from March 2003 through March 2004 according to generally accepted government auditing standards.

**Scope Limitation.** Although there are basic ordering agreements and provisional item orders that qualify as UCAs, we did not review them because there is not a uniform database in DoD to identify the universe or applicable contracting office.

**Contacts During the Audit.** We visited or contacted individuals and organizations within the Military Departments. Further details are available on request.

**General Accounting Office High-Risk Area.** The General Accounting Office has identified several high-risk areas in DoD. This report pertains to GAO high-risk area Defense Contract Management. Implementation of the recommendations will improve processes and controls to reduce contract risk in UCA execution.

## Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," dated August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

**Scope of Review of Management Control Program.** We reviewed the adequacy of Army, Navy, and Air Force management control programs covering award and definitization of UCAs. We reviewed the management control program, assessable unit and policy used to manage undefinitized contractual actions. A copy of the report will be provided to the senior official in charge of management controls for the Army, Navy, and Air Force.

**Adequacy of Management Controls.** We identified material weaknesses as defined by DoD Directive 5010.38. For the Army, Navy, and Air Force contracting organizations visited, weaknesses varied among the activities to

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maintain management control programs that covered all the restrictions and implementing requirements on the use of UCAs. Furthermore, although the contracting organizations generally maintained a system to identify and track UCAs, lack of detail in the management control plan did not provide for review of either the justification adverse impact or allowable profit being evaluated.

If management implements all the report recommendations, then the UCA award, definitization, and reporting processes would improve, and potential monetary benefits could be realized. However, we could not determine the monetary benefits amount because the amount will depend on the value of future UCA awards.

**Adequacy of Management’s Self-Evaluation.** Army, Navy, and Air Force officials did not consistently identify the UCA award and negotiation process as a separate assessable unit. Therefore, the Military Departments did not identify or report on the material management control weaknesses identified by the audit.

## Prior Coverage

During the last 5 years, there has been 4 reports issued that discusses undefinitized contractual actions. Additionally, the Inspector General of the Department of Defense (IG DoD) issued an audit report in 1997 on undefinitized contractual actions based on the same statutory requirement as this report. As a result, the audit report title, number and date is listed below. Unrestricted IG DoD reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

### IG DoD

IG DoD Report No. 97-204, “Undefinitized Contractual Actions,”  
August 15, 1997

### Navy

Naval Audit Service Audit Report, “Fiscal Year 2002 Implementation of the Federal Managers’ Financial Integrity Act at Selected Navy Activities,”  
March 26, 2003

Naval Audit Service Audit Report, “Administering Contracting Actions Without Prices at Supervisors of Shipbuilding, Conversion, and Repair,” June 2, 1998,  
Report No. 038-98

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## **Air Force**

Air Force Audit Agency Installation Audit, "Undefinitized Contract Actions,  
Electronic Systems Center, Hanscom AFB MA," July 31, 2001,  
Report No. DH001019

Air Force Audit Agency Installation Audit, "Undefinitized Contractual Actions,"  
December 14, 2000, Report No. DI001014

## Appendix B. Undefined Contract Actions (Letter Contracts) Issued and Definitized

### Letter Contracts Issued:

Fiscal Year	Army		Navy		Air Force		Marine Corps		Defense Agencies		Total	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1998	143	\$308,554,132	47	\$484,374,155	98	\$638,033,006			27	\$26,191,894	315	\$1,457,153,187
1999	112	145,762,930	38	1,480,360,449	126	1,956,753,521	1	\$ 6,573,000	19	21,750,131	296	3,611,200,031
2000	107	287,857,551	36	1,745,896,143	74	1,536,111,012			20	99,948,512	237	3,669,813,218
2001	92	447,486,054	60	501,447,821	72	1,106,099,177	3	4,075,201	43	124,421,699	270	2,183,529,952
2002	76	404,095,257	110	374,154,820	86	706,711,428	5	10,078,460	58	83,059,076	335	1,578,099,041
<b>Total</b>	<b>530</b>	<b>\$1,593,755,924</b>	<b>291</b>	<b>\$4,586,223,388</b>	<b>456</b>	<b>\$5,943,708,144</b>	<b>9</b>	<b>\$20,726,661</b>	<b>167</b>	<b>\$355,371,312</b>	<b>1,453</b>	<b>\$12,499,795,429</b>

### Letter Contracts Definitized:

Fiscal Year	Army		Navy		Air Force		Defense Agencies		Total	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1998	13	\$ 9,695,963	8	\$ 16,219,125	16	\$ 54,920,320	11	\$ 25,486,548	48	\$ 106,321,956
1999	44	161,928,544	14	56,446,788	38	127,719,314	18	92,185,961	114	438,280,607
2000	68	260,846,617	44	396,351,975	85	373,251,344	19	136,571,220	216	1,167,021,156
2001	52	257,346,369	41	1,083,106,902	107	1,262,732,869	19	26,888,000	219	2,630,074,140
2002	65	314,085,689	53	1,331,586,307	86	1,771,339,200	21	59,044,487	225	3,476,055,683
<b>Total</b>	<b>242</b>	<b>\$1,003,903,182</b>	<b>160</b>	<b>\$2,883,711,097</b>	<b>332</b>	<b>\$3,589,963,047</b>	<b>88</b>	<b>\$340,176,216</b>	<b>822</b>	<b>\$7,817,753,542</b>

Contract data from the Defense Contract Action Data System was obtained on February 13, 2003.

# Appendix C. Summary of Letter Contracts Reviewed at Contracting Organizations

Contracting Organizations	Letter Contracts Reviewed	Ceiling Price Amount	Amount Definitized	Insufficient Adverse Impact		Awards for Known Acquisition Requirements	UCAs Undefined After 180 Days		Average Days From Contract Award to Definitization	Allowable Profit Not Reported
				No Adverse Impact	Adverse Impact Support		Yes	No		
<b>Army</b>										
Aviation and Missile Command Communications and Electronics Command	15	\$570,062,751	\$567,970,528	1	0	3	12	3	251	13
Defense Contracting Command-Washington	14	\$136,655,611	\$134,851,898	1	0	0	8	6	219	11
<b>Total Army</b>	<b>32</b>	<b>\$15,425,000</b>	<b>\$30,269,194</b>	<b>0</b>	<b>1</b>	<b>2</b>	<b>0</b>	<b>3</b>	<b>131</b>	<b>2</b>
<b>Navy</b>										
Naval Air Systems Command	8	\$241,882,593	\$299,943,755	0	0	5	6	2	261	8
Naval Sea Systems Command	9	\$518,052,752	\$728,265,504	4	0	7	8	1	422	5
<b>Total Navy</b>	<b>17</b>	<b>\$759,935,345</b>	<b>\$1,028,209,259</b>	<b>4</b>	<b>0</b>	<b>12</b>	<b>14</b>	<b>3</b>	<b>337</b>	<b>13</b>
<b>Air Force</b>										
Aeronautical Systems Center*	8	\$107,195,705	\$78,697,517	0	1	1	3	2	163	6
Oklahoma Air Logistics Command*	15	\$129,142,532	\$101,205,023	0	2	0	2	11	165	15
<b>Total Air Force</b>	<b>23</b>	<b>\$236,338,237</b>	<b>\$179,902,540</b>	<b>0</b>	<b>3</b>	<b>1</b>	<b>5</b>	<b>13</b>	<b>190</b>	<b>21</b>
<b>Total Military Departments</b>	<b>72</b>	<b>\$1,718,416,944</b>	<b>\$1,941,203,419</b>	<b>6</b>	<b>4</b>	<b>18</b>	<b>39</b>	<b>28</b>	<b>239</b>	<b>60</b>

\*Includes Definitization Waivers

# Appendix D. Detailed Results of Letter Contracts Reviewed

Contracting Organizations	Letter Contracts Reviewed	Ceiling Price Amount	Amount Definitized	Insufficient		Known Prior Requirement	Definitized After 180 Days	Days From Contract Award to Definitization	Allowable Profit Not Reported
				No Adverse Impact	Adverse Impact Support				
Army Aviation and Missile Command	DAAH01-98-C-0197	\$12,410,000	\$12,410,000				✓	315	✓
	DAAH23-98-C-0028	\$13,440,000	\$23,764,873				✓	194	✓
	DAAH23-98-C-0047	\$5,757,791	\$2,281,754				✓	448	✓
	DAAH23-98-C-0058	\$15,702,000	\$13,500,000				✓	215	✓
	DAAH01-99-C-0004	\$13,423,754	\$13,665,302				✓	343	✓
	DAAH01-99-C-0077	\$20,650,000	\$19,396,636	✓		✓		149	✓
	DAAH23-99-C-0054	\$14,693,000	\$14,183,274					139	✓
	DAAH23-00-C-0347	\$45,720,806	\$42,968,572				✓	188	✓
	DAAH01-01-C-0133	\$164,888,000	\$152,407,301				✓	309	✓
	DAAH23-01-C-0018	\$35,000,000	\$33,089,554			✓		182	✓
	DAAH23-01-C-0036	\$18,595,500	\$28,197,444				✓	408	✓
	DAAH23-01-C-0101	\$16,311,900	\$13,843,374				✓	243	✓
	DAAH01-02-C-0075	\$145,000,000	\$144,928,936				✓	324	✓
	DAAH01-02-C-0093	\$21,590,000	\$21,590,000					83	✓
	DAAH23-02-C-0045	\$26,880,000	\$31,743,508			✓		224	N/A
Defense Contract Command Washington	DASW01-01-C-0015	\$9,425,000	\$9,424,929		✓			132	✓
	DASW01-01-C-0022	\$5,700,000	\$20,544,265					149	✓
	DASW01-02-C-0033	\$300,000	\$300,000			✓		111	N/A

<u>Contracting Organizations</u>	<u>Letter Contract Reviewed</u>	<u>Ceiling Price Amount</u>	<u>Amount Definitized</u>	<u>No Adverse Impact</u>	<u>Justification Deficiencies</u>		<u>Known Prior Requirement</u>	<u>Definitized After 180 Days</u>	<u>Days From Contract Award to Definitization</u>	<u>Allowable Profit Not Reported</u>	
					<u>Insufficient Adverse Impact Support</u>	<u>Insufficient Adverse Impact</u>					
Electronics Command	DAAB07-98-C-K310	\$3,298,273	\$3,135,926						47	✓	
	DAAB07-98-C-S004	\$9,999,999	\$9,300,010						133	✓	
	DAAB07-98-C-S602	\$3,500,000	\$6,100,000	✓				✓	251	✓	
	DAAB07-99-C-A502	\$1,080,000	\$843,770						90	N/A	
	DAAB07-99-C-D305	\$6,911,500	\$6,727,838					✓	265	✓	
	DAAB07-00-C-L004	\$1,400,000	\$2,801,226					✓	555	✓	
	DAAB07-00-C-L006	\$20,738,402	\$33,676,486					✓	255	✓	
	DAAB07-01-C-A617	\$13,307,008	\$8,880,480					✓	208	✓	
	DAAB07-01-C-L304	\$27,400,000	\$22,633,993					✓	246	✓	
	DAAB07-02-C-A501	\$777,895	\$722,690						124	✓	
	DAAB07-02-C-E201	\$13,816,534	Undefinitized					✓	264 <sup>3</sup>		
	DAAB07-02-C-J003	\$22,920,000	\$29,775,567					✓	373	✓	
	DAAB07-02-C-L606	\$6,606,000	\$6,606,000						178	✓	
	DAAB07-02-C-P620	\$4,900,000	\$3,647,922						118	✓	
	<b>Total Army</b>		<b>\$722,143,362</b>	<b>\$733,091,621</b>	<b>2</b>	<b>1</b>	<b>5</b>	<b>20</b>			<b>26</b>
	<b>Navy</b>										
Naval Air Systems Command											
Naval Air Systems Command	N00019-98-C-0039	\$7,250,000	\$9,150,000					✓	229	✓	
	N00019-98-C-0112	\$9,400,000	\$20,720,153					✓	246	✓	
	N00019-99-C-1069	\$24,800,000	\$56,494,184						167	✓	
	N00019-99-C-1090 <sup>1</sup>	\$81,354,444	\$687,995,761						264		
	N00019-99-C-1175 <sup>1</sup>	\$22,000,000	\$824,772,275						449		
	N00019-99-C-1226 <sup>1</sup>	\$80,000,000	\$1,906,770,865						488		
	N00019-00-C-0178	\$42,000,000	\$41,423,000						225	✓	
	N00019-00-C-0183 <sup>1</sup>	\$86,395,189	Undefinitized					✓	ongoing		
	N00019-00-C-0184 <sup>1</sup>	\$5,177,735	Undefinitized						ongoing		

Contracting Organizations	Letter Contract Reviewed	Ceiling Price Amount	Amount Definitized	Justification Deficiencies			Definitized After 180 Days	Days From Contract Award to Definitization	Allowable Profit Not Reported
				Insufficient Adverse Impact Support	Known Prior Requirement	Days From Contract Award to Definitization			
	N00019-00-C-0249	\$37,200,000	\$75,300,000		✓		147	✓	
	N00019-01-C-0012	\$95,207,562	\$71,500,000		✓		305	✓	
	N00019-01-C-0147 <sup>1</sup>	\$80,826,475	\$322,623,000				55		
	N00019-01-C-0223	\$13,000,000	\$13,000,000		✓		567	✓	
	N00019-01-C-0267 <sup>1</sup>	\$2,896,000	Undefinitized				ongoing		
	N00019-02-C-3084	\$13,025,031	\$12,356,418		✓		205	✓	
Naval Sea Systems Command	N00024-98-C-4039	\$80,000,000	\$160,011,000	✓	✓		966	✓	
	N00024-98-C-5199	\$113,000,000	\$111,040,512	✓	✓		147	✓	
	N00024-99-C-5110	\$78,900,000	\$88,598,211		✓		292	N/A	
	N00024-99-C-5373	\$135,236,244	\$130,347,531	✓	✓		371	✓	
	N00024-01-C-2224 <sup>1</sup>	\$171,050,850	Undefinitized				ongoing		
	N00024-01-C-4010	\$21,060,000	\$144,819,613		✓		308	✓	
	N00024-01-C-4055	\$6,119,862	\$14,575,019	✓	✓		545	✓	
	N00024-01-C-5369	\$67,795,666	\$78,873,618		✓		328	N/A	
	N00024-02-C-2206	\$7,605,000	Undefinitized		✓		523 <sup>3</sup>		
	N00024-02-C-2207	\$8,336,000	Undefinitized		✓		517 <sup>3</sup>		
<b>Total Navy</b>		<b>\$1,289,636,038</b>	<b>\$4,770,321,160</b>	<b>4</b>	<b>12</b>	<b>0</b>	<b>14</b>	<b>13</b>	
Air Force Aeronautical Systems Center	F33657-98-C-0037 <sup>1</sup>	\$23,985,000	\$23,759,520				51		
	F33657-99-C-0036 <sup>1</sup>	\$275,400,000	\$818,371,400				629		
	F33657-99-C-0050	\$9,100,000	\$5,336,275			✓	324	✓	
	F33657-00-C-0013 <sup>1</sup>	\$227,000,000	\$350,823,056				329		
	F33657-00-C-0020 <sup>1</sup>	\$40,000,000	\$2,416,282,558				374		
	F33657-00-C-2120	\$6,410,713	\$6,130,859		✓		113	✓	
	F33657-01-C-0027	\$4,680,000	\$3,326,140				180	✓	

Contracting Organizations	Letter Contract Reviewed	Ceiling Price Amount	Amount Definitized	Justification Deficiencies			Days From Contract Award to Definitization	Allowable Profit Not Reported
				No Adverse Impact	Insufficient Adverse Impact Support	Known Prior Requirement		
	F33657-01-C-2095 <sup>1</sup>	\$26,000,000	\$3,254,332,820				490	
	F33657-01-C-4600	\$45,000,000	\$36,913,380		√		316	N/A
	F33657-01-C-4601 <sup>1</sup>	\$20,524,297	\$97,907,192				438	
	F33657-02-C-0004 <sup>2</sup>	\$3,150,000	\$3,150,000				182	√
	F33657-02-C-4060	\$14,643,992	Undefinitized		√		386 <sup>3</sup>	
	F33657-02-C-5403 <sup>2</sup>	\$9,586,000	\$9,321,275				248	√
	F33657-02-C-5404 <sup>2</sup>	\$14,625,000	\$14,519,588				312	√
	F33657-02-C-5422 <sup>1</sup>	\$30,290,000	\$302,922,125				248	
Oklahoma Air Logistics Command	F34601-99-C-0096	\$81,200,000	\$67,481,846				178	√
	F34601-99-C-0275	\$2,272,150	\$1,664,225				140	√
	F34601-99-C-0277	\$3,246,000	\$3,333,364			√	221	√
	F34601-99-C-0350	\$2,705,419	\$1,798,400				178	√
	F34601-99-C-0355	\$1,306,700	\$365,787				174	√
	F34601-99-C-0368	\$8,541,600	\$845,265		√		176	√
	F34601-99-C-0379	\$3,049,081	\$2,810,002				179	√
	F34601-00-C-0054	\$2,464,848	\$2,263,392		√		166	√
	F34601-00-C-0222	\$2,725,000	\$2,390,000				115	√
	F34601-00-C-0253	\$6,727,976	\$6,574,779				93	√
	F34601-00-C-0354	\$2,300,000	\$2,060,486				77	√
	F34601-01-C-0268	\$2,505,587	\$2,324,000				151	√
	F34601-01-C-0316	\$2,500,000	\$2,440,000			√	257	√
	F34601-01-C-0458 <sup>2</sup>	\$4,221,745	\$2,478,641				191	√
	F34601-02-C-0159 <sup>2</sup>	\$3,376,426	\$2,374,836				173	√
<b>Total Air Force</b>		<b>\$879,537,534</b>	<b>\$7,444,301,211</b>	<b>0</b>	<b>3</b>	<b>1</b>	<b>5</b>	<b>21</b>
<b>Total Military Depts.</b>		<b>\$2,891,316,935</b>	<b>\$12,947,763,991</b>	<b>6</b>	<b>4</b>	<b>18</b>	<b>39</b>	<b>60</b>

<sup>1</sup> Advance Procurement

<sup>2</sup> Definitization Waiver

<sup>3</sup> Undefinitized as of date of completion of field work at audit site

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## **Appendix E. Distribution List**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
Director, Defense Procurement and Acquisition Policy  
Under Secretary of Defense (Comptroller)/Chief Financial Officer  
Director, Program Analysis and Evaluation  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)

### **Department of the Army**

Assistant Secretary of the Army (Acquisition, Logistics, and Technology)  
Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Research, Development and Acquisition)  
Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Assistant Secretary of the Air Force (Acquisition)  
Auditor General, Department of the Air Force

### **Combatant Command**

Inspector General, U.S. Joint Forces Command

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## **Non-Defense Federal Organizations and Individuals**

Office of Management and Budget  
Office of Federal Procurement Policy

## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Reform  
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform  
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform  
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform



# Department of the Army Comments

Final Report  
Reference



DEPARTMENT OF THE ARMY  
OFFICE OF THE ASSISTANT SECRETARY OF THE ARMY  
ACQUISITION LOGISTICS AND TECHNOLOGY  
103 ARMY PENTAGON  
WASHINGTON DC 20310-0103

1 JUL 2004

SAAL-PP

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF  
DEFENSE, ATTN: DIRECTOR, CONTRACT  
MANAGEMENT DIRECTORATE, 400 ARMY  
NAVY DRIVE, ARLINGTON, VA 22202-4704

SUBJECT: Draft Report on Undefined Contractual Actions  
(Project No. D2003CF-0072)

Enclosure 1 contains our management comments regarding the findings and recommendations included in the subject report. Enclosures 2 and 3 contain the responses received from the field contracting offices relative to the specific contractual actions reviewed during the audit process. Please contact Ms. Tina M. Grove at (703)604-7141 regarding this response.

*For E. Ballard Deputy*  
E. Ballard  
Deputy Assistant Secretary of the Army  
(Policy and Procurement)

Enclosures

Enclosures 2 and 3 are omitted but are available upon request.

MANAGEMENT COMMENTS  
FOR DRAFT DODIG AUDIT REPORT ON UNDEFINITEZED CONTRACTUAL  
ACTIONS (UCAs)  
(PROJECT NO. D2003CF-0072)

1. DEFICIENCY FINDINGS –

a. The DODIG reviewed 72 of the 1453 letter contracts issued by the military departments during the period FY 1998 to FY 2002. Selected judgmentally from the total universe, these 72 contracts have a total value of \$1.7 billion. Thirty-two of the reviewed contracts, or 44 percent, are Army contracts at three contracting activities. Deficiency findings on Army contracts consisted of the following:

1) Issuance Without Adequate Justification – ten stated deficiencies [on eight different contracts – 25 percent of reviewed contracts].

b) Untimely or No Contract Definitization – 20 stated deficiencies [62.5 percent of reviewed contracts].

c) Insufficient Justification for Negotiated Allowable Profit Rate – 27 stated deficiencies [84 percent of reviewed contracts].

b. Two of the three applicable Army contracting activities provided comments relative to the findings – this represents 91 percent of the DODIG reviewed contracts and 95 percent of the stated deficiencies. The field comments are provided as enclosures to this memorandum. The summary comments on the DODIG findings are:

1) Issuance Without Adequate Justification – of the ten stated deficiencies: three nonconcurrences; one concurrence; two partial concurrences; and four "no comments" were received from the field.

b) Untimely or No Contract Definitization – of the 20 stated deficiencies: nine nonconcurrences; eight concurrences; and three partial concurrences were received from the field.

c) Insufficient Justification for Negotiated Allowable Profit Rate – of the 27 stated deficiencies: 15 nonconcurrences; nine concurrences; one partial concurrence; and two "no comments" were received from the field.

c. As stated in the DODIG report, the results of the DODIG review cannot be used to project DOD-wide findings due to incomplete information on the UCAs and errors in the Defense Contract Action Data System (DCADS). Also, the disparity between the DODIG findings and the comments from the field creates a

**MANAGEMENT COMMENTS  
FOR DRAFT DODIG AUDIT REPORT ON UNDEFINITEZED CONTRACTUAL  
ACTIONS (UCAs)  
(PROJECT NO. D2003CF-0072)**

difficult and complex situation in which to accurately assess the extent of problems with statutory compliance. It appears that additional dialog between the auditors and the contracting activities would increase the comprehension of exactly what is contained in the contract files.

**2. RECOMMENDATIONS -**

We recommend that the Assistant Secretary of the Army (Acquisition, Technology and Logistics), Assistant Secretary of the Navy (Research, Development, and Acquisition), and Assistant Secretary of the Air Force (Acquisition):

a. Prepare specific instructions, for use by the field activities when issuing letter contracts for the procurement of goods and services, outlining the requirement to assess the adverse impact to support issuance of a letter contract.

**MANAGEMENT COMMENT - Nonconcur.** The requirement for the contracting officer to assess the adverse impact to support issuing a letter contract is already provided for in DFARS 217.7404-1(a).

b. Require contracting officers to document the adverse impact in the contract file if the procurement is delayed.

**MANAGEMENT COMMENT - Nonconcur.** DFARS 217.7404-1(a) already states that the contracting officer's request for approval to enter into a UCA must include the adverse impact on agency requirements resulting from delays in beginning performance.

c. Require justification documents for all letter contracts that provide specific details on the procurement planning performed.

**MANAGEMENT COMMENT - Nonconcur.** DFARS 217.7404-1(a) already states that the contracting officer's request for approval for entering into a UCA must fully explain the need to begin performance before definitization.

d. Require contracting officers to provide written justification in the contract files for surpassing DFARS definitization schedule milestones.

**MANAGEMENT COMMENTS  
FOR DRAFT DODIG AUDIT REPORT ON UNDEFINITEZED CONTRACTUAL  
ACTIONS (UCAs)  
(PROJECT NO. D2003CF-0072)**

**MANAGEMENT COMMENT – Partially Concur.** DFARS 217.7404-3 does not specifically address the scope of contract file data for instances of exceeding the 180 day definitization schedule. Also, per AFARS 5116.603-2(c)(3) the Principle Assistants Responsible for Contracting (PARCs) may authorize an additional period subject to the limitations in DFARS 217.7404-3. In letter guidance, we will reiterate the statutory requirements relative to the definitization of UCAs and the importance of documenting the circumstances affecting the definitization schedule.

e. Develop implementing guidance on the allowable profit requirements as defined in DFARS 217.7404-6, "Allowable Profit."

**MANAGEMENT COMMENT - Nonconcur.** DFARS 217.7404-6 already states that the HCA shall ensure that the profit allowed reflects (A) any reduced cost risk to the contractor for costs incurred during contract performance before negotiation of the final price; and (B) the contractor's reduced cost risk for costs incurred during performance of the remainder of the contract. It is noted that the DODIG report does not quantify whether "a substantial portion of the required performance has been completed" for the contracts at issue. The dissenting comments from the field overwhelmingly indicate that the appropriate effort was undertaken in developing pre-negotiation positions and that documentation has been included in the contract files.

f. Require contracting officers to document the basis for the allowable profit determination on letter contracts in the price negotiation memorandum.

**MANAGEMENT COMMENT - Nonconcur.** DFARS 215.406-3(a)(10), Documenting the negotiation, states that the negotiation documentation (B) should include the DD Form 1547, Record of Weighted Guidelines Application, if used, with supporting rationale; and (C) must address the rationale for not using the weighted guidelines method when its use would otherwise be required by DFARS 215.404-70. Based on dissenting comments from the field in this area, the DODIG findings do not appear to adequately represent the actual contents of the contract files.

**3. MATERIAL MANAGEMENT CONTROL WEAKNESSES –**

a. Adequacy of Management Controls. Although the contracting organizations generally maintained a system to identify and track UCAs, lack of

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**MANAGEMENT COMMENTS  
FOR DRAFT DODIG AUDIT REPORT ON UNDEFINITEZED CONTRACTUAL  
ACTIONS (UCAs)  
(PROJECT NO. D2003CF-0072)**

detail in the management control plan did not provide for review of either the justification adverse impact or allowable profit being evaluated.

**MANAGEMENT COMMENT** – Letter guidance will be provided to the contracting activities reiterating the statutory requirements relative to the issuance, definitization and documentation of UCAs.

b. Adequacy of Management's Self-Evaluation. Contracting officials did not consistently identify the UCA award and negotiation process as a separate assessable unit. Therefore, the Military Departments did not identify or report on the material management control weaknesses identified by the audit.

**MANAGEMENT COMMENT** – Letter guidance will be provided to the contracting activities reiterating the statutory requirements relative to the issuance, definitization and documentation of UCAs.

# Department of the Navy Comments

Final Report  
Reference



DEPARTMENT OF THE NAVY  
OFFICE OF THE ASSISTANT SECRETARY  
RESEARCH, DEVELOPMENT AND ACQUISITION  
1000 NAVY PENTAGON  
WASHINGTON, DC 20350-1000

JUN 25 2004

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING,  
CONTRACTS MANAGEMENT DIRECTORATE,  
DEPARTMENT OF DEFENSE

Subj: DRAFT REPORT ON UNDEFINITIZED CONTRACTUAL ACTIONS  
(Project D2003CF-0072)

Ref: (a) DoDIG memo of 30 Apr 04

Encl: (1) Additional information on NAVAIR contracts reviewed

The reference (a) memorandum requested that we review and comment on the subject report. This draft report provides six recommendations for processing Undefinitized Contractual Actions (UCAs) to the three military services reviewed. Since these recommendations should be applicable uniformly to processing UCAs by all Defense Department contracting activities, we feel the recommendations should properly be addressed to the Undersecretary of Defense (Acquisition, Technology & Logistics).

The Naval Air Systems Command submitted additional information on two of the contracts reviewed to improve the factual content of the draft report. This is provided in enclosure (1).

A handwritten signature in black ink, appearing to read "M. E. [unreadable]".

M. E. [unreadable]  
Chief of Staff/Policy  
for DASN (ACQ)

Copy to:  
NAVIG

Enclosure 1  
was omitted  
but is  
available  
upon  
request.

# Department of the Air Force Comments

Final Report  
Reference



Office Of The Assisitant Secretary

DEPARTMENT OF THE AIR FORCE  
WASHINGTON DC 20330-1060

25 JUN 2004

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING  
OFFICE OF THE INSPECTOR GENERAL

FROM: SAF/AQ  
1060 Air Force Pentagon  
Washington, DC 20330-1060

SUBJECT: Draft of a Proposed Report on Undefined Contractual Actions (UCA) (Project  
No. D2003CF-0072)

This is in reply to your memorandum requesting the Assistant Secretary of the Air Force (Financial Management and Comptroller) to provide Air Force comments on the draft report.

We agree that it is important to manage letter contracts. Comments to contracts listed in your report are in Attachment 1. Our comments to your specific recommendations follow.

Recommendation 1: Prepare specific instruction, for use by the field activities when issuing letter contracts for the procurement of goods and services outlining the requirement to assess the adverse impact to support issuance of a letter contract.

Comment: Concur. DFARS 217.7404-1 (a), "Authorization," requires 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. Since the documentation requirement already exists in DFARS, we do not believe there is a need to issue additional instructions. AF contracting activities prepare UCA approval documentation for all actions. The actual document varies by organization and is located in each contract file. For example, AFMC's Aeronautical Systems Center uses a Management Control Document (MCD)(AFMC Form 224) to justify a UCA. As a result, the UCA details may not be totally described in the price negotiation memorandum. Therefore, both documents must be reviewed when reviewing file documentation.

We agree to reemphasize this requirement. Air Force Materiel Command conducts quarterly video teleconferencing conferences (VTC) with its Policy Chiefs to discuss important issues. They will reemphasize this requirement again in the July 04 Policy Chiefs VTC.

Recommendation 2: Require contracting officers to document the adverse impact in the contract file if the procurement is delayed.

Attachment  
1 was  
omitted but  
is available  
upon  
request.

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Comment: Concur. This discussion is part of the rationale justifying a letter contract required by DFARS and discussed in the response to Recommendation 1. AFMC will include this topic in the July 04 Policy Chiefs VTC.

Recommendation 3: Require justification documents for all letter contracts that provide specific details on the procurement planning performed.

Comment: Concur. Acquisition planning in FAR 7.105(b)(4)(i) requires a discussion of contract type selection (part 16) or other special contracting methods (part 17) for each contract contemplated. The justification for a letter contract is part of this documentation. AFMC will also discuss this subject during the July 04 Policy Chiefs VTC.

Recommendation 4: Require contracting officers to provide written justification in the contract files for surpassing DFARS definitization schedule milestones.

Comment: Concur. However, instead of just requiring written contracting officer justification, we will further strengthen management reporting for late definitizations. Currently, the Air Force Federal Acquisition Regulation Supplement (AFFARS) requires the UCA approval authority to report to SAF/AQC any UCA that is more than one year old. The report serves as the written documentation and brings management attention to late definitizations. However, we note that the UCA approving authorities have not submitted a report since this requirement was instituted and we plan to investigate why. In addition, we intend to change the AFFARS reporting requirement to match the DFARS requirement of 180 days. We will revise the AFFARS by 30 September 04.

Recommendation 5: Develop implementing guidance on the allowable profit requirement as defined in DFARS 217.7404-6, "Allowable Profit."

Comment: Concur. The Air Force agrees that the implementing guidance needs improvement. AFMC/PK will reinforce in its pricing training classes and upcoming pricing training modules the importance of clear and concise documentation. In particular, future training will emphasize the need for contracting officers to document the basis of the allowable profit determination and reasonableness of the negotiated profit rates on letter contracts in the PNM. AFMC will use FY05 funds for this effort. In addition, the Air Force Weighted Guidelines Tool is currently under revision to include a breakout of UCAs under contract type. This will allow the contracting officer the ability to adjust the profit/fee for lower risk due to actuals incurred. The anticipated completion date for the pricing training modules is 30 June 05 and 30 September 04 for the Weighted Guidelines Tool.

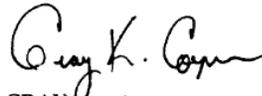
Recommendation 6: Require contracting officers to document the basis for the allowable profit determination on letter contracts in the price negotiation memorandum.

Comment: Concur. The Air Force agrees that better documentation is required. Therefore, AFMC/PK will reinforce this requirement in pricing training classes and upcoming pricing training modules. It will include the importance of documenting in the price negotiation memorandum the relationship of the actuals incurred to the profit/ fee negotiated. The training

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and the previously identified changes to the Weighted Guidelines Tool will allow the contracting officer the ability to calculate the profit/fee correctly and we will reinforce the documentation with training. As stated in the previous comment, the anticipated date for the pricing training modules is 30 June 05, and the Weighted Guideline Tool's anticipated release is 30 September 04.

Regarding the comment concerning the Management Control Program Review, we will ask our major commands to review their plans during the next cycle to determine if the UCA award and negotiation process should become an assessable unit. Estimated completion date is September 2004.



GRAY K. COYNER, Col, USAFR  
Associate Deputy Assistant  
Secretary (Contracting)  
Assistant Secretary (Acquisition)

Attachment:  
Comments on Letter Contracts

## **Team Members**

The Office of the Deputy Inspector General for Auditing of the Department of Defense, Contract Management prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

David K. Steensma  
Terry L. McKinney  
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Martin I. Gordon  
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Monelle K. Riviere  
Lavina Mensah  
Sherney Alexander  
Theresa L. Tameris