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United States General Accounting Office

GAO

High-Risk Series

December 1992

Farmers Home
Administration's Farm
Loan Programs





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

Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

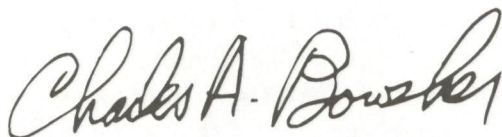
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Farmers Home Administration's (FmHA) direct and guaranteed farm loan programs and about the agency's management of farm properties obtained as a result of defaults on federal loans. It focuses on the failure of FmHA field office lending officials to comply with existing loan and property management standards and on program policies that contribute to financial risks. We have made numerous recommendations to the Congress and to the Secretary of Agriculture that are aimed at improving program management and reducing risk.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Agriculture.



Charles A. Bowsher

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Overview

The Farmers Home Administration (FmHA), an agency of the U.S. Department of Agriculture (USDA), is the third largest institutional lender to the nation's agricultural sector. Its mission is to provide temporary financial assistance to farmers who are unable to obtain commercial loans at reasonable rates and terms.

FmHA has two principal and often conflicting roles: (1) to provide high-risk borrowers with temporary credit to enable them to stay in farming until they are able to secure commercial credit and (2) to do so in a way that protects the taxpayers' investment.

The Problem

FmHA's loan program is marred by a high rate of defaults. This past April, we published a study of FmHA's outstanding loans as of September 30, 1990. This study revealed that of FmHA's roughly \$20 billion direct loan portfolio, 70 percent—or more than two-thirds—was held by borrowers who were either delinquent or whose loans had been restructured as a result of, or to avoid, delinquency. Because of defaults, in recent years FmHA reduced or forgave delinquent debt totaling about \$7.6 billion.

Furthermore, FmHA has evolved into a continuous source of subsidized credit for nearly half of the agency's borrowers. As repeated loan servicing has increased their debt and reduced their equity, some FmHA borrowers have actually had their financial condition worsen.

The Causes

FmHA and the Congress share responsibility for many of FmHA's problems. Although some contributing factors—such as the general decline of the agricultural economy in the 1980s—have been beyond the control of FmHA or the Congress, two major ones do lie within their authority. First, FmHA field office lending officials often fail to follow the agency's own standards for making loans, servicing loans, and managing property. Second, FmHA loan- and property-management policies—some of which are congressionally directed—do not adequately protect the taxpayers' interests. For example, these policies allow borrowers who have defaulted on past FmHA loans to obtain new ones.

GAO's Suggestions for Improvement

We have recommended that FmHA establish a system to ensure that its field office lending officials adhere to the agency's loan

standards and that the Congress enact various policy and program changes to reduce the assistance program's exposure to risk.

However, losses can be expected to continue until the Congress tells FmHA how to better balance its mission of assisting financially troubled farmers with its obligation to provide that assistance in a fiscally responsible manner. We believe that, to protect the taxpayers' interests, the balance should be shifted more toward prudent lending.

Furthermore, we believe that the Congress needs to recognize that not all financially stressed farms can be saved and that not all farm families can be expected to benefit from a government assistance program intended to keep them in farming. With this in mind, the Congress should, among other things, give FmHA firm guidance on the following: (1) the level of loan losses that the Congress is willing to accept; (2) the length of time over which borrowers should be allowed to receive FmHA assistance; and (3) the kind of assistance, if any, that should be made available to unsuccessful borrowers who want to leave farming.

FmHA's Farm Loan Programs

Under the authority of the Consolidated Farm and Rural Development Act, as amended—known as the Con Act—FmHA provides financial assistance to farmers through direct loans, which are funded by the government, and through guaranteed loans, which are made by commercial lenders and guaranteed up to 90 percent by the government. To be eligible for a direct loan, a borrower must be unable to obtain commercial credit at reasonable rates and terms. To obtain a loan guarantee, a lender must certify that it is unwilling to make the loan without a guarantee. As of September 30, 1990, FmHA's \$23.6 billion farm loan portfolio comprised \$19.5 billion in direct loans and \$4.1 billion in guaranteed loans. By June 30, 1992, the total portfolio had decreased to about \$20.5 billion—\$15.9 billion in direct loans and \$4.6 billion in guaranteed loans.

FmHA incurs a loss on a direct or a guaranteed farm program loan when a borrower defaults and the proceeds from selling the loan collateral do not equal the outstanding loan amount plus the costs of acquiring and disposing of the collateral. FmHA also incurs interest subsidy expenses because it (1) lends money at rates below its cost of borrowing and (2) provides payments

to commercial lenders so that they will lend money at rates below their cost of borrowing.

When a borrower is unable to repay a loan, FmHA may acquire the farm property that was pledged as security for the loan and subsequently try to sell that property to recover some or all of the unpaid debt. As of June 30, 1992, FmHA's inventory comprised almost 3,100 farms valued at about \$400 million. The Con Act provides several options for a former owner to recover a farm property after it has entered FmHA's inventory, such as leasing or purchasing either the entire farm property or the farm homestead, including farm buildings and up to 10 acres of land.

Billions of Dollars Are at Risk

In recent years, FmHA has provided about \$7.6 billion in debt relief to delinquent borrowers in addition to interest subsidies. Despite relief of this magnitude, billions of dollars more in outstanding direct and guaranteed loans are held by borrowers who are unlikely to meet some or all of their loan obligations.

Billions of Dollars in Debt Relief Provided to Delinquent Borrowers

During fiscal years 1989 through the first three quarters of 1992, FmHA forgave about \$3.1 billion in direct loan obligations under the debt-servicing provisions of the Agricultural Credit Act of 1987, writing down (reducing) some debts by about \$1.2 billion and writing off (forgiving) other obligations by about \$1.9 billion. FmHA wrote off another \$4.5 billion in the course of settling direct loan obligations with borrowers who had generally ceased to farm.

During this 3-3/4-year period, FmHA also paid commercial lenders about \$200 million to cover guaranteed loan losses.

Billions of Dollars Still at Risk

FmHA's farm loan portfolio continues to be financially stressed. As of June 30, 1992, borrowers were delinquent on \$7.6 billion, or about 37 percent, of the \$20.5 billion in

outstanding loans—about \$7.3 billion of the \$15.9 billion direct and about \$300 million of the \$4.6 billion guaranteed loan debt.

However, the amounts owed by borrowers classified as delinquent represent only part of the risk associated with FmHA's portfolio. Additional risk is posed by the substantial portion of FmHA's borrowers who are technically current but whose loans have been restructured (loan terms have been rescheduled or debts reduced) in response to past defaults or rescheduled to avoid delinquency. As we estimated in Farmers Home Administration: Billions of Dollars in Farm Loans Are at Risk (GAO/RCED-92-86, Apr. 3, 1992), as of September 30, 1990, 70 percent of FmHA's direct loan portfolio was held by borrowers who either were delinquent (\$8 billion, or 40 percent of total outstanding direct loans) or whose loans had been restructured as a result of, or to prevent, delinquency (\$5.9 billion, or 30 percent).

As of September 30, 1990, FmHA categorized about 28 percent of its guaranteed loan portfolio as a potential loss. FmHA revised its estimates of potential losses on guaranteed loans to about 18 percent as of September 30, 1991.

Agency Standards Have Not Been Implemented Effectively

Ineffective implementation of agency standards has significantly weakened FmHA's financial position. In both the direct and guaranteed loan programs, FmHA field office lending officials often fail to implement loan-making and loan-servicing standards established by the agency to safeguard federal financial interests. In addition, field office officials often do not follow standards for managing farm inventory property.

Noncompliance With Loan-Making Standards

In the direct loan program, FmHA field office lending officials often approve loans based on unrealistic estimates of production, income, and expenses. FmHA reviews of direct loans made from fiscal years 1988 through 1991 disclosed that 554 sampled loans, or 13.5 percent of the 4,101 loans reviewed, did not meet the lenient cash flow standard that FmHA uses to test a borrower's repayment ability. Fiscal year 1992 reviews through June 30, 1992, disclosed that 10 percent of the 653 loans reviewed did not meet this key FmHA standard. Our own work suggests that some FmHA officials consider making loans more important than adhering to the agency's loan-making standards. For example, when one loan applicant's actual production yields were too low to demonstrate a positive cash flow, a county

supervisor substituted higher county averages in order to approve a \$49,000 loan. The next year, the borrower, who had other outstanding FmHA loans, defaulted and subsequently received \$122,000 in debt relief.

Also, in the direct loan program, FmHA field office officials often fail to verify borrowers' existing debts, as required. FmHA reviews in fiscal year 1991 showed that borrowers' debts had not been verified for 18 percent of the loans sampled; reviews in the first three quarters of fiscal year 1992 showed that debts had not been verified for 20 percent of the loans sampled. One borrower who was \$545,000 delinquent on loans from one county office moved to another county and applied at a second office for new financing without disclosing the delinquent debt. The county supervisor in the second office did not verify the borrower's debts and approved two new loans totaling about \$33,000. The borrower subsequently defaulted on the new loans.

In the guaranteed loan program, FmHA field office lending officials often fail to enforce requirements that commercial lenders comply with FmHA's loan-making standards. FmHA reviews of guaranteed loans made from

**Agency Standards Have Not Been
Implemented Effectively**

fiscal years 1988 through 1991 showed that 349 sampled loans, or 13.4 percent of the 2,613 loans reviewed, did not meet FmHA's cash flow standard. In the first three quarters of fiscal year 1992, about 8 percent of the 585 loans reviewed did not meet this standard. One borrower received four guaranteed loans totaling almost \$533,000. Each loan had problems indicating that it should not have been approved: Projected yields were not based on production records, debt payments and operating expenses were understated, and security was overvalued. The borrower subsequently defaulted on two of the loans and FmHA paid a lender's \$251,000 loss claim.

**Noncompliance
With
Loan-Servicing
Standards**

In the direct loan program, FmHA field office officials have not always, as required, annually inspected property offered as loan collateral or conducted supervisory visits with borrowers. Consequently, property securing FmHA loans has disappeared or deteriorated. For example, according to a USDA Office of Inspector General (OIG) report, property pledged as loan security and valued at about \$92 million was missing, and livestock valued at about \$36 million had been disposed of without FmHA's authorization. FmHA reviews in fiscal year

1991 and the first three quarters of fiscal year 1992 disclosed that about 12 percent of the sampled loans showed no evidence that collateral had been inspected.

FmHA's loan-servicing standards also require field office officials annually to analyze borrowers' operations, assist borrowers in developing and using sound farming and management practices, and help borrowers plan for future farming operations. FmHA reviews in fiscal year 1991 and the first three quarters of fiscal year 1992 found that 20 percent and 15 percent of the sampled loans, respectively, had no evidence of such activities. An FmHA supervisor at one county office with 122 borrowers told us that he had never analyzed the operations of any of them.

In the guaranteed loan program, the story is similar. FmHA field office officials have not always, as required, monitored commercial lenders' compliance with standards for inspecting collateral, providing the same servicing for FmHA-guaranteed loans as for other loans, and ensuring proper uses of loan funds. FmHA reviews in fiscal year 1991 and the first three quarters of fiscal year 1992 showed that field office officials had not reviewed commercial lenders' servicing of

about 25 percent and 31 percent, respectively, of the sampled loans.

Noncompliance With Standards for Managing Inventory Property

FmHA owns about \$400 million worth of farm real estate that it acquired from borrowers who did not repay their loans. Protecting the taxpayers' interest requires prudent management of this property, but FmHA field office officials often fail to follow agency standards for leasing, inspecting, appraising, and maintaining farm inventory properties. According to the OIG, properties have frequently been used without FmHA's permission, rented without written leases, or leased for amounts below prevailing rental rates. The OIG disclosed in one report that 74 percent of 57 properties reviewed in 10 states had not been maintained well enough to protect the government's interest. The OIG disclosed in another report that it had found errors or omissions on appraisals for 46 of 95 farm properties that it reviewed. In an earlier review, we found no record of property appraisal reviews for 69 of 72 properties that we analyzed in seven states.

Reasons for Noncompliance With Agency Standards

FmHA has not systematically analyzed why its standards have not been implemented. Agency officials have suggested various reasons for noncompliance, including

**Agency Standards Have Not Been
Implemented Effectively**

limited resources, insufficient training, and lack of accountability on the part of lending officials. In the direct loan program, some FmHA officials seem to believe that keeping farmers on the land is more important than making prudent lending decisions. In the guaranteed loan program, FmHA's emphasis on making loans has left the impression that the number of loans is more important than their quality. Furthermore, violation of property management standards reflects, in part, FmHA's having given higher priority to making and servicing loans than to managing inventory property. In addition, the agency has placed responsibility for managing the properties in the local county offices, where officials frequently have too few properties to manage to become familiar with applicable standards.

Some Policies Are at Odds With Fiscal Controls

Violation of FmHA's standards is not the only problem. In some cases, loan-making, loan-servicing, and inventory property management policies themselves increase FmHA's vulnerability to loss. Reflecting the Congress's and FmHA's goal to keep farmers in farming, these policies often show little regard to cost and are frequently inconsistent with the prudent management that would protect taxpayers' interests.

Lax Loan-Making Policies

FmHA's policies for making both direct and guaranteed loans, some congressionally directed, expose the agency to loss. First, borrowers who have defaulted on past loans are free to obtain new loans. Specifically, borrowers whose delinquent direct loan debts have been written down or written off may receive new loans. We identified 1,335 borrowers who had obtained about \$89 million in direct or guaranteed loans from fiscal year 1989 through the first three quarters of fiscal year 1992 after having previously received about \$203 million in debt relief. Furthermore, we identified 45 borrowers who had received \$5.4 million in new guaranteed loans after FmHA had paid \$3.3 million in loss claims on their previous guaranteed loans. One borrower received a \$132,000 direct loan even though, just 2

months earlier, he had received about \$428,000 in debt relief. Another borrower received a \$176,400 guaranteed loan just 6 months after FmHA had paid \$173,200 in loss claims on his previous guaranteed loans.

Second, under a congressionally directed policy, borrowers can obtain new FmHA direct loans for operating expenses without demonstrating the ability to pay their existing FmHA debt. This policy enables borrowers who are delinquent on their outstanding obligations to incur further obligations. From fiscal year 1988 through the first three quarters of fiscal year 1992, FmHA lent about \$107 million to delinquent borrowers. FmHA first established this policy in 1982 to assist financially stressed borrowers during a slump in the agricultural economy. It rescinded the policy in 1985 following our disclosure that many unsound loans were being made. However, in 1987, the Congress directed FmHA to reinstate the policy to prevent farmers from failing. FmHA officials said, and our work confirmed, that this policy makes it difficult for them to act in a fiscally prudent manner.

Third, the criteria that FmHA has established for approving loans further expose the agency's portfolios to loss. The cash flow

method that FmHA uses to calculate a loan applicant's ability to repay a debt includes no provision for contingencies and often creates an overly optimistic picture of the applicant's financial circumstances. In 1987, FmHA proposed regulations to strengthen its loan-approval criteria. FmHA withdrew the proposal in part because Members of Congress expressed concern that the proposed regulations would render many borrowers ineligible for farm loans.

Fourth, under provisions of the Con Act and FmHA's implementing regulations, private lenders can use guaranteed loans to refinance existing customers' debts and thereby shift to the federal government most of the risks of their loans to financially stressed borrowers. About \$550 million, or 44 percent, of the \$1.2 billion in guaranteed loan obligations in fiscal year 1988 was used to refinance borrowers' existing debts with lenders. Commercial lenders view FmHA's guaranteed loans primarily as a vehicle for increasing the security of their own agricultural loan portfolios. Experience has shown that this practice is risky for the government. The OIG has reported that 35 of 45 borrowers who defaulted on guaranteed loans had obtained the loans to refinance existing debt. Sixty percent of these 35

borrowers defaulted shortly after receiving the loans, often without having made a single payment.

Finally, FmHA's policy is to guarantee most loans at the maximum rate (90 percent), regardless of risk, even though the agency has authority to accept a smaller share of the risk. As we reported in April 1992, about 81 percent of all guaranteed loans have been guaranteed at the 90-percent level. Loans to borrowers who have defaulted on previous loans are guaranteed at the same rate as loans to borrowers with more solid credit histories. Loans for refinancing existing debt are guaranteed at the same rate as loans for new credit purchases. This policy strengthens the incentive for commercial lenders to use the guaranteed loan program as a way of transferring the risks in their own loan portfolios to the federal government.

Imprudent Loan-Servicing Policies

FmHA's policies governing loan servicing, some the result of legislation, also invite losses. To keep borrowers' loans technically current, FmHA routinely reschedules and reamortizes loan terms, thereby extending the period for repaying a loan. Typically, FmHA adds the unpaid interest to the

outstanding loan principal without increasing the loan security. These actions often result in excessive debt and loss of equity for borrowers and undersecured loans for the government. Although the Con Act limits borrowers to \$200,000 in new direct loan obligations, it does not limit the debt that they can accumulate through rescheduling or reamortizing existing loans. We identified 1,940 borrowers who, as of June 30, 1992, had accumulated debts totaling about \$67 million in excess of the individual \$200,000 limit.

In addition, although FmHA requires borrowers to pledge adequate security for new loans to ensure repayment in the event of default, it does not, when rewriting a loan, require additional security. Therefore, the new principal balance may exceed the value of the loan security. If the borrower defaults, the collateral may no longer cover the debt. As we reported in February 1989, loan security was inadequate for 111 of 160 borrowers in our sample.

The Agricultural Credit Act of 1987 also established a policy for servicing delinquent debts that runs counter to principles of sound financial management: debt write-down for borrowers whose loans are

restructured and debt write-off for borrowers whose loans do not qualify for restructuring. These practices are expensive for the taxpayer—costing about \$3.1 billion during fiscal years 1989 through the first three quarters of 1992—and also provide incentives for farmers to default intentionally on their loans in order to qualify for debt reduction. As we reported in August 1990, 18 of 30 nondelinquent borrowers whom we interviewed told us that they felt penalized for paying their debts, and some said that they were looking for ways to become delinquent so that they could qualify for debt reduction.

FmHA's debt-restructuring practices have generally failed to strengthen the financial positions of delinquent borrowers. In many instances, the beneficiaries of these actions have returned for additional debt restructuring, continuing the delinquency-restructuring-delinquency cycle. As our August 1990 report disclosed, over 90 percent of the 160 borrowers whom we reviewed remained financially weak after their delinquent debts were restructured. According to FmHA, about 9,500 borrowers, or about 43 percent of those whose delinquent loans were restructured from November 1988 to March 1990, became

delinquent again. Furthermore, we identified 6,222 borrowers who received multiple debt restructuring from January 1989 to June 1992. For example, one delinquent borrower's loans were restructured in 1989. At that time, he received a \$65,760 write-down. In 1990, he was delinquent again, his debt was once more restructured, and he received another loan. In 1991, he was delinquent again and received still another loan.

Costly Policies for Managing Inventory Property

The Con Act, as amended by various laws, requires FmHA to dispose of its inventory of farm properties in ways that are inconsistent with prudent management, reducing the government's opportunity to recoup losses. FmHA is required to determine whether a property is suitable for agricultural use and, if it is, to offer it at a fixed price to selected buyers, such as former owners or new farmers, to enable them to continue farming or to start new operations. These requirements may prevent the agency from obtaining the highest selling price and, by extending the time that properties remain in inventory, increase property management costs. Furthermore, this costly practice may not even promote farming and is subject to abuse by some targeted buyers. For

Some Policies Are at Odds With Fiscal Controls

example, one former owner who repurchased property sold part of the land 17 months later for almost twice as much as he had paid FmHA for the entire property. In 1991, he was developing part of the remaining land for commercial use.

Clarification of FmHA's Role Is Necessary

FmHA has neither acted as a prudent lender nor enhanced the creditworthiness of the nation's financially stressed farmers. As the lender of last resort to borrowers whom commercial lenders do not consider creditworthy, FmHA would be expected to incur some losses through defaults on loans as well as through interest subsidies. However, the billions of dollars in direct loans that FmHA has already lost or may lose in the future far exceed the losses that might be anticipated even for a lender of last resort. Furthermore, the guaranteed loan program, which may grow significantly in the coming years, is vulnerable to loss because it is experiencing many of the same problems as the direct loan program.

Neither FmHA nor the Congress could have controlled some factors that have contributed to the agency's losses, such as the general decline of the agricultural economy in the 1980s. However, other factors contributing to FmHA's problems have been within FmHA's and/or the Congress's ability to influence. FmHA has failed its responsibility to manage its farm loan programs in that

- it has not ensured adherence to agency standards,
- it has adopted program policies that have increased the government's exposure to risk, and
- it has not provided its managers with the information that they have needed to operate programs effectively.

But by emphasizing FmHA's role as an assistance agency over its role as a prudent lender, the Congress may have contributed more to FmHA's problems than have deficiencies in the agency's program management. In 1987, the Congress discouraged FmHA's efforts to impose more stringent loan-making standards, and it directed FmHA to reinstate the policy of making operating loans to borrowers who are unable to pay their existing FmHA debt. The Congress also, through the Agricultural Credit Act of 1987, allowed delinquent farmers to obtain billions of dollars in debt relief and created incentives for nondelinquent borrowers deliberately to become delinquent.

More than fraud or other illegal attempts to circumvent established financial controls,

these practices and policies—while well-intentioned—have jeopardized the federal government's multibillion-dollar investment in farm loans. Furthermore, although these actions by FmHA and the Congress have reflected a desire to help farmers remain in farming until they could secure commercial credit, they have failed in many instances to achieve this objective. Nearly half of FmHA's borrowers have come to rely on the agency as a continuous source of subsidized credit. Moreover, the financial condition of some of these borrowers has deteriorated over time as repeated loan servicing has increased their debt and reduced their equity.

Conclusions and Action Needed

FmHA has not succeeded in operating simultaneously as a fiscally prudent lender and as an assistance agency. We believe that, to protect taxpayers' funds, a shift in the agency's emphasis toward prudence is in order. However, the Congress is ultimately responsible for defining FmHA's role and deciding how fiscally prudent the lender of last resort to the nation's farmers should be.

We have made numerous recommendations to the Secretary of Agriculture and to the Congress to improve compliance with loan and property management standards and to strengthen policies and program design in the direct loan, guaranteed loan, and farm inventory property areas. For example, we recommended in our April 1992 report that

- FmHA establish a system to ensure that lending officials adhere to the agency's loan standards,
- the Congress enact legislation to prohibit delinquent borrowers from receiving direct loans,
- the Congress enact legislation to require FmHA to establish a range of guarantees that places the highest percentage guarantee on the least risky loan and a lower percentage

guarantee on the most risky loan, and

- the Congress enact legislation to require that FmHA use competitive methods in selling farm inventory properties.

Many of our recommendations were directed toward improving FmHA's program management. However, if the losses in FmHA's programs are to be brought under control, the Congress needs to make clear that it expects FmHA to act as a prudent lender. In our opinion, the Congress needs to recognize that not all marginal, financially stressed farm operations can be saved and that not all farm families can benefit from attempts to keep them in farming. To communicate this recognition to FmHA and its managers, the Congress should, among other things, establish guidance concerning (1) the level of loan losses that it is willing to accept, (2) the length of time that borrowers may receive financial assistance from FmHA, and (3) the type of assistance, if any, that should be made available to help unsuccessful borrowers who want to leave farming.

Related GAO Products

Farmers Home Administration: Billions of Dollars in Farm Loans Are at Risk
(GAO/RCED-92-86, Apr. 3, 1992).

Farmers Home Administration: Debt Relief Actions for Business Entity Borrowers Are Questionable (GAO/RCED-92-29, Dec. 10, 1991).

ADP Modernization: Half-Billion Dollar FmHA Effort Lacks Adequate Planning and Oversight (GAO/IMTEC-92-9, Oct. 29, 1991).

Financial Audit: Farmers Home Administration's Financial Statements for 1989 and 1988 (GAO/AFMD-91-36, May 6, 1991).

Farmers Home Administration: Sales of Farm Inventory Properties (GAO/RCED-91-98, Apr. 9, 1991).

Farmers Home Administration: Changes Needed in Loan Servicing Under the Agricultural Credit Act (GAO/RCED-90-169, Aug. 2, 1990).

Farmers Home Administration: Use of Loan Funds by Farmer Program Borrowers
(GAO/RCED-90-95BR, Feb. 8, 1990).

Financial Audit: Farmers Home Administration's Financial Statements for 1988 and 1987 (GAO/AFMD-90-37, Jan. 25, 1990).

Farmers Home Administration: Implications of the Shift From Direct to Guaranteed Farm Loans (GAO/RCED-89-86, Sept. 11, 1989).

Information Management: Issues Important to Farmers Home Administration Systems Modernization (GAO/IMTEC-89-64, Aug. 21, 1989).

Farmers Home Administration: Sounder Loans Would Require Revised Loan-Making Criteria (GAO/RCED-89-9, Feb. 14, 1989).

Financial Audit: Farmers Home Administration's Losses Have Increased Significantly (GAO/AFMD-89-20, Dec. 20, 1988).

Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit (GAO/RCED-89-3, Nov. 22, 1988).

Farmers Home Administration: Problems and Issues Facing the Emergency Loan Program (GAO/RCED-88-4, Nov. 30, 1987).

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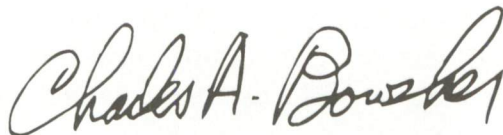
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We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the ability of the U.S. Customs Service to effectively enforce the trade laws and maintain effective financial controls.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, the Secretary-designate of the Treasury, and the Commissioner of Customs.

A handwritten signature in black ink that reads "Charles A. Bowsher". The signature is written in a cursive style with a large, prominent initial "C".

Charles A. Bowsher

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Overview

The Customs Service is responsible for guarding the nation's borders and enforcing trade laws and policies that protect against the introduction of foreign goods that threaten U.S. health, safety, or economic well-being. Attendant to its trade enforcement mission, Customs is the government's second largest revenue collection agency; it reported collections of over \$16 billion in fiscal year 1991. Confronted during the 1980s with increasing levels of imports, demands to balance its efforts to enforce the trade laws with those of facilitating the flow of cargo, and limited resources, Customs instituted automated systems to speed up the flow of goods and target imports for review through the Automated Commercial System (ACS).

The Problem

Customs' efforts to speed up the flow of goods were successful, but Customs cannot ensure that it is meeting its responsibilities to combat unfair foreign trade practices or protect the public from unsafe goods. Customs did not detect about 84 percent of the estimated trade law violations in imported cargo during fiscal year 1991. Moreover, Customs has experienced declines in the percentage of estimated

cargo violations detected since calendar year 1988.

Furthermore, Customs' financial management system has a range of weaknesses, including the absence of reliable information on operating costs and the status of accounts receivable, a lack of data integrity in the general ledger, contract payments made without proof of delivery or acceptance of goods and services, and weaknesses in its internal controls over the payment of overtime to Customs inspectors.

The Causes

Customs lacks an effective strategic management process capable of guiding its operations and establishing accountability for performance. Its current 5-year plan does not set forth a clear objective for its trade enforcement activities, prioritize its numerous objectives, or adequately articulate a means of fully automating customs transaction processing. Further, Customs is experiencing related weaknesses in information management, financial management, human resource management, performance measurement, and organizational structure. Left uncorrected, these weaknesses could hinder Customs'

capacity to meet the challenges of the changing world trade environment.

**GAO's
Suggestions for
Improvement**

Over the past several years, Customs has achieved some successes. The trade community, for example, has agreed that ACS, the core information system for customs transaction processing that was introduced during the 1980s, has been effective in meeting its needs. Furthermore, Customs has been able to arrange broad agreement among the diverse interests within the trade community in support of legislation to enable Customs to proceed toward full automation of the customs transaction process.

As Customs pursues its plans to fully automate customs transaction processing, it must be sure to develop the management processes needed to meet its trade enforcement responsibilities. To its credit, Customs is actively addressing the management problems identified by us and others. It has initiated a program of financial reforms and established task forces to address needed improvements in its trade enforcement efforts, strategic management processes, and the management of its information and human resources.

The success of these efforts will be influenced by how well Customs (1) develops and gains acceptance for a comprehensive trade enforcement strategy, (2) corrects its long-standing financial management problems, and (3) has the support and oversight it needs from the Congress and the Office of Management and Budget (OMB) to help it focus on key strategic and organizational issues and achieve fundamental management improvements.

Customs' Key Trade Enforcement Efforts

The American public relies on the U.S. Customs Service—a key agency responsible for guarding the nation's borders—to enforce trade laws and policies against the introduction into the country of foreign goods that threaten our health, safety, or economic well-being. Customs confronts continuing challenges to its efforts to effectively enforce the trade laws. Between 1980 and 1990, the volume of imports that Customs processed more than doubled, from about 4.4 million to 9.2 million. Rapid changes in world business patterns, such as free trade agreements and “just in time” inventory systems, increase the complexity of the import control function and heighten demands on Customs to release goods quickly. Finally, the pressures on the resources available for Customs' trade enforcement have been aggravated by the agency's increasing involvement in the war on drugs. During the 1980s, resources for narcotics enforcement increased 324 percent compared to a 115-percent increase for trade activities.

As a primary border enforcement agency, the Customs Service works with 40 other government agencies to enforce over 400 laws. Customs' trade enforcement responsibilities rest primarily with its

inspectors and import specialists. Inspectors are responsible for the actual inspection of cargo at the nation's docks, airports, and land borders to ensure compliance with the trade laws. Faced with an expanding volume of imports, inspection efforts are targeted, largely through the criteria within the Cargo Selectivity System (CSS), toward those imports deemed to represent the highest risk. In fiscal year 1991, Customs performed 522,000 inspections, which was about 8 percent of all imports.

Import specialists draw upon the knowledge they develop about specific commodity areas to review a variety of documents importers are required to submit to ensure that the proper amount of duties and fees are paid on merchandise and to verify that imports comply with various quota and other restrictions. The Entry Summary System (ESS) is designed to select documents for import specialist review on the basis of risk criteria. In fiscal year 1991, approximately 8 million import documents were submitted to import specialists.

When Customs detects noncompliance with regulations, fraud, or other illegal acts, it will assess and seek to collect fines or penalties and/or seize the merchandise. While

**Customs' Key Trade Enforcement
Efforts**

inspectors, import specialists, or special agents assess penalties and make seizures, it is the fines, penalties, and forfeitures (FP&F) staff that is responsible for making sure civil enforcement cases are properly processed and that penalties are collected.

Strategic Direction for Operations Not Adequate

Customs needs an effective strategic management process capable of guiding operations and establishing accountability for performance. Customs' current 5-year plan does not set forth a clear objective for its trade enforcement activities. Trade enforcement needs to be defined in terms of increased detection of violations, increased voluntary compliance by importers, increased collections of duties, or some comparable objective. A clearer objective would also help Customs personnel balance their efforts among numerous enforcement programs and between the goals of enforcing the trade laws while also facilitating the flow of goods.

The 5-year plan also does not prioritize its numerous objectives or adequately articulate how to fully automate Customs' transaction processing, the cornerstone of its efforts for meeting its trade enforcement responsibilities. Eliminating these weaknesses would improve the plan's usefulness in guiding operations and establishing accountability for performance.

Accountability for performance could also be improved. This could be accomplished by making better use of information for management decisionmaking. For example,

each year Customs conducts thousands of random cargo examinations—nearly 53,000 in fiscal year 1991—to deter importers from bringing merchandise into the country in violation of laws or restrictions and to assess the risk-targeting capabilities of CSS. However, the information from its random cargo exams could also be used to develop estimates of the violations in all cargo imports. Without the benefit of this latter information, Customs was unaware that the effectiveness of its cargo inspection activities had been declining over the past 3 years, both in terms of detecting estimated violations and in achieving acceptable levels of voluntary compliance.

Another change that is needed to correct problems related to Customs' operational performance is the development of an institutional standard for measuring the significance of trade violations. Right now, Customs does not have a good basis for determining whether it is focusing its limited resources on the most important violations. Marking violations—inaccurate representations of required information on imports—represent over 60 percent of the violations discovered during the past 3 years. And Customs officials generally agree that

marking violations are the least significant category.

Customs recognized that the assessment and collection of fines, penalties, and forfeitures is the foundation of efforts to ensure compliance with the trade laws and regulations. Currently, efforts are under way to redesign the FP&F information system. Quick action by Customs to include the capability to compare actual collections to penalty assessments, or to monitor collection performance by field location, would enhance its ability to effectively use this key enforcement tool.

Various studies by others have also identified weaknesses in certain key management processes. For example, Customs' internal management assessments have usually been too narrowly focused to identify the root cause of program management problems and would be more useful if done more routinely. Further, Customs is not aggressive enough in ensuring that recommended corrective actions are implemented. Finally, more specific performance standards in senior executive contracts are needed to measure managers' success in achieving agency goals.

Status of Agency
Efforts

In response to our recommendations regarding strategic planning and trade enforcement, Customs has initiated efforts to develop a trade enforcement strategy, reevaluate its selectivity systems, and improve its planning process. As a result of these efforts, Customs stated that its trade enforcement objective is to ensure a high level of voluntary compliance by the trade community. Customs has not yet released the details of its trade enforcement strategy. However, Customs has outlined plans that promise to significantly improve its selectivity systems. The incoming Commissioner will need to ensure that progress on these important efforts is sustained.

Ineffective Information Resources Management Hampers Mission Accomplishment

Customs has not managed its information resources effectively, thereby limiting the availability of information needed by employees for program execution and oversight. Also, Customs employees often lack basic information needed to assess the effectiveness of trade enforcement efforts. These conditions arise because of weaknesses in two key areas related to how Customs manages its information resources.

Planning Efforts Not Sufficiently Focused on Trade Enforcement Mission

In developing ACS during the 1980s, Customs management was able to overcome long-standing obstacles to automating the import filing process and produce a system that the trade community overwhelmingly agreed has been effective in meeting its needs for quickly processing imports. Thus, Customs has been successful in meeting one of its objectives for ACS.

However, Customs' second objective for ACS was to develop a system useful for detecting shipments that violate U.S. laws. Customs officials acknowledge that this objective received limited attention during ACS planning. Consequently, ACS is not serving as an effective resource for managers and field staff to enforce compliance with the multitude of trade laws or to measure the

**Ineffective Information Resources
Management Hampers Mission
Accomplishment**

effectiveness of the agency's programs. For example, ESS—the automated system within ACS that determines which import documents will be reviewed—operated for over 3 years without Customs achieving the capability to compare entry document review results with the specific criteria prompting the review. This capability is critical to both assessing the effectiveness of selectivity criteria and analyzing violation trends.

Further, ESS does not readily identify why an import specialist receives entry documents for review. The importance of this information increases when entry documents contain multiple items of imported merchandise. Without this information, an import specialist does not know what needs to be reviewed.

**Customs Did Not
Adhere to
Systems
Development
Guidelines**

In developing and implementing its information systems, Customs did not adhere to federal information systems guidelines. This delayed the implementation of key information systems. For example:

- In 1989, Customs began developing an in-house Asset Information Management System (AIMS) without performing a feasibility study to determine whether it

**Ineffective Information Resources
Management Hampers Mission
Accomplishment**

would be more cost efficient to meet its financial information needs through use of an off-the-shelf software package. After 3 years of in-house development and expenditures of over \$4 million, Customs did a feasibility study that prompted it to abandon its in-house efforts.

- From the initial design of ESS in 1987 to the present, Customs did not prepare feasibility studies, risk or cost-benefit analyses, or development and implementation plans. Customs implemented the first phase of ESS without fully testing the system. As a result, import specialist reviews are being hampered because they are experiencing difficulty getting key information on why an entry document was selected for review.

**Status of Agency
Efforts**

Customs is taking a number of positive steps to improve planning and make better use of its information resources to enforce the trade laws. It has slowed the pace of ACS development and implementation to help the broker community keep pace with the changes taking place in the processing of imported cargo. It has shifted responsibility for defining information needs from the ACS systems analysts to program personnel. It is exploring ways of making more effective use

**Ineffective Information Resources
Management Hampers Mission
Accomplishment**

of the trade data residing in ACS without impeding progress toward the system's primary function of expediting the release of cargo. And Customs has implemented the ESS history file, which should enable it to better evaluate the effectiveness of its automated criteria. These actions are commendable. But to maximize their potential to succeed, the incoming commissioner will also need to

- identify program and cross-functional information needs,
- prepare an information and systems architecture that shows how information technology will fit into the agency's overall trade enforcement strategy and prescribes the critical characteristics of the equipment and resources needed to meet current and future needs,
- adhere to federal system development guidelines, and
- evaluate the effectiveness of its information resources management activities.

Better Accountability and Stronger Controls Needed Over Customs' Resources

Customs continues to face the challenge of establishing adequate accountability and control over its resources. Stronger controls for identifying and collecting fees owed and for debt collection would have produced greater success in collecting millions of dollars in user fees and delinquent accounts receivable. Further, Customs' automated and manual accounts receivable systems would be more useful if they contained more complete and accurate data. Finally, Customs needs to improve both its accounting for and controls over property.

Implement Stronger Controls Over Revenue

Stronger internal controls governing the efforts of Customs import specialists to determine whether appropriate duties are paid would produce more revenues. Limitations in the capabilities of ESS leave Customs without assurance of the effectiveness of its efforts to target high-risk import documents for review. ESS has not had a history file to monitor the results of its reviews to either confirm the current selection criteria or to develop a valid basis for changing them. Although Customs randomly selected about 93,700 entry documents for review in fiscal year 1990, it was not able to use the results of these reviews to develop estimates of overall

**Better Accountability and Stronger
Controls Needed Over Customs'
Resources**

importer compliance with tariff provisions because there is currently no standardized way to capture and analyze the results of the reviews.

Strengthening internal controls over other Customs revenue-generating activities could also benefit the agency. Currently, Customs does not routinely compare the amount of user fees collected from airline carriers and exporters with amounts owed. Customs' own fiscal year 1990 review at 1 airport showed that 6 of 10 carriers had underpaid passenger user fees by \$1.9 million. Also, when Customs recently compared export shipment data with collection information, it discovered that some exporters shipped goods out of the country without paying harbor maintenance fees.

**System
Improvements
and Better
Controls Needed
Over Debt
Collection**

Customs' delinquent accounts receivable totaled almost \$344 million as of September 30, 1991. Customs could increase its capability to collect these receivables by upgrading its systems so it could monitor such important information as the age of receivables and the sufficiency of the bonds required to cover the value of importer activity. Also, Customs could make greater use of its authority to impose sanctions

(restricting import activity through Customs) against delinquent importers and sureties. Such actions could also help it collect delinquent debts in a timely manner and, thereby, increase revenue.

More Reliable
Financial
Management
Systems Needed

Customs' accounting and internal control systems do not give management complete and accurate information to effectively manage its resources. No single accounts receivable system currently captures all amounts (duties, fees, fines, and penalties) owed Customs from the time of assessment to collection. As a result, Customs must manually prepare financial reports using information from a number of automated and manual systems. For example, the FP&F system contains information on the fines and penalties assessed violators of trade laws, but Customs does not establish these amounts as individual accounts receivable or summarize this information in the primary accounting system or in financial reports. The manual preparation of financial reports on accounts receivable is labor intensive and increases the opportunity for inaccurate reporting.

Also, differences totaling \$61.8 million existed between Customs' property system

and its primary accounting system in fiscal year 1991. Part of these differences can be attributed to the lack of adequately trained personnel. For example, some property officers were not aware that the method used to process property acquisitions can affect how property is recorded in the system. An additional factor contributing to these differences was improper classification of property acquisitions. Financial records showed considerable confusion among Customs personnel in deciding when to expense property items and when to capitalize them.

Also, contingent liabilities were not disclosed in the notes to the financial statements to account for refunds that were likely to be made to exporters who apply for refund of duties collected on merchandise initially imported and now being exported—known as drawbacks.

**Status of Agency
Efforts**

Customs has recognized many of its financial system problems, and top management has expressed its resolve to correct them under the framework of the Chief Financial Officers (CFO) Act. Under the direction of its CFO, a number of initiatives are under way, such as an effort to develop a new financial

**Better Accountability and Stronger
Controls Needed Over Customs'
Resources**

management system. The incoming
Commissioner's involvement and
commitment will be essential to achieving an
effective financial management environment.

Insufficient Attention Given to Human Resources Management

Customs is confronting a number of human resource management (HRM) issues that diminish its ability to effectively enforce trade laws and improve organizational performance. For example, reviews conducted by a Customs-established Blue Ribbon Panel and by the Treasury Inspector General in 1991 found that

- performance ratings had no relationship to actual performance and
- the process for dealing with ineffective supervisors and managers did not work, and employees whose performance was considered inadequate did not receive such feedback from supervisors.

Customs' managers and brokers also expressed concerns regarding the adequacy of training efforts, despite the recent expansion of the training program and the revamping of some existing courses. In response to a GAO questionnaire, over 40 percent of Customs managers expressed concerns about the management training they received, training for their staffs, and time and funding provided for training.

Further, 54 percent of customs brokers viewed the turnover of Customs staff as

negatively affecting job knowledge and the quality of service. The majority of Customs managers also thought that staff changes were too frequent and had a negative effect on their work.

Better Processes and Structure Needed to Address HRM Problems

Customs has established ambitious HRM objectives for increasing the professionalism of its workforce. However, its ability to achieve these objectives and address its workforce problems are limited by weaknesses in its HRM processes and structure. Customs does not have a comprehensive HRM plan that supports organizational goals. Further, it does not routinely analyze information for evaluating key HRM issues. For example, Customs does not routinely account for agencywide training expenditures, collect reliable information on the courses offered throughout its units, or track the training histories of its personnel.

Also, the limited capabilities of the central personnel and training offices diminish their ability to lead an effective agencywide HRM effort. For example, the Office of Human Resources is faced with an inappropriate organizational structure, erroneous data in automated systems, paperwork processing

delays, understaffing, inadequate staff training, a high turnover rate, and recruiting delays.

**Status of Agency
Efforts**

Customs has initiated a number of HRM efforts. It has established HRM objectives in its 5 year plan, formed an Office of Organizational Effectiveness headed by an Associate Commissioner to correct problems pointed out by the external reviews conducted in 1991, and has surveyed employees to determine what job benefits they would like. To maximize its potential to address its workforce problems, Customs needs to develop a (1) planning process that targets key HRM issues and is tied to the budget process; (2) workforce planning capability that identifies the number of people and types of skills needed and areas where problems may occur; (3) training program to enhance employee development and productivity; and (4) capability to monitor, evaluate, and update information that affects HRM goals. Instituting this management system will also require sustained commitment from the incoming Commissioner and his or her team.

Organizational Structure Hinders Mission Accomplishment

Changes in Customs' organizational structure must accompany efforts to improve management processes. Successful accomplishment of the trade enforcement mission requires effective coordination of the efforts of the offices of Inspection and Control, Commercial Operations, and Enforcement. However, 49 percent of Customs' managers feel that there is not a high level of cooperation or coordination among programmatic units. In 1991, an internal Customs study concluded that the FP&F program is the foundation on which Customs' enforcement mission rests because all the resources expended in any enforcement action are wasted unless they result in a penalty, fine, or forfeiture. However, the study found that Customs' components lacked a general understanding of the relationship between their functions and the FP&F program.

Another problem with the organizational structure is that Customs' reliance on its 7 regions to oversee operations in the 44 districts is not ensuring consistent policy implementation. For example, headquarters inspection and control program managers were unable to overcome field opposition to instituting a standard method for tracking the quality of cargo examinations.

There are two reasons for the problems. First, Customs' headquarters structure divides policymaking offices by job function (such as inspections, duty assessment and collection, and criminal enforcement) rather than aligning them by mission. This functional division encourages top policymakers to focus on functional concerns, as opposed to mission effectiveness, and places the responsibility for managing conflicting priorities and integrating cross-office functions in the Commissioner's office.

Second, a structural emphasis is placed on geographic diversity by the dispersion of line authority from the Commissioner's office directly to regional offices, which develop independent policies based upon regional priorities. This diversity conflicts with the agency's objective of maintaining uniform programs and again places the responsibility for ensuring consistent policy implementation in the Commissioner's office.

The result is an overload of management circuits in the offices of the Commissioner and Deputy Commissioner, which are the only offices with the formal authority to ensure agencywide consistency and

coordinate the functionally divided components that carry out the agency's mission. The current structure essentially mandates that the Commissioner's office manage the details of the work—a job that should be delegated to subordinate managers. This structure takes away from the time the Commissioner and Deputy Commissioner can devote to their leadership responsibilities.

Status of Agency
Efforts

We recommended that Customs closely examine its current structure with the objective of reorganizing the agency to better achieve the trade enforcement mission. Serious consideration should be given to reorganizing headquarters offices according to broadly defined mission components and vesting the top officials in these offices with line authority over field operations. Any reorganization should be based on a clearly communicated statement of Customs' mission and a translation of this mission into a comprehensive trade enforcement strategy.

Any complete study of Customs' organization should also address the agency's field structure. Customs studies have identified the need for revisions to the

field structure on the basis of findings of wide variations among the districts' workloads and resources. It is very likely that Customs' plans to fully automate its transaction process will lead to centralized document filing by the trade community. This could lead to centralizing the duty assessment function performed by import specialists, with implications for the current configuration of Customs' districts and ports.

However, current appropriations legislation restricts Customs from planning or implementing changes to the current field structure. We have recommended that the Congress remove those legislative restrictions. If the Congress does remove such restrictions, we recommend that Customs examine its field structure and consider consolidating districts to improve accountability and reduce unnecessary expense. Again, such an examination should be done within the framework of Customs' plans for enforcing the trade laws as it moves to fully automated customs transaction processing.

In a recent status report on efforts to address the recommendations in our general management review, Customs agreed that

**Organizational Structure Hinders
Mission Accomplishment**

we had identified some valid organizational issues. However, Customs said that any actions to overhaul its organizational structure would await the outcome of the efforts it has under way to address the other management problems we identified, and action by the Congress to remove the legislative restriction that prohibits Customs from changing its current field structure. We believe that Customs' approach is reasonable.

Conclusions and Action Needed

Customs has initiated a broad range of efforts to address management problems identified by us and others. Although Customs is making a good faith effort to formulate and implement plans, the permanency of these plans is fragile at this point because of the early stage they are in and the disruptions that may accompany the transition to the new administration. Therefore, priority attention from the new Commissioner will be crucial to ensuring that current efforts are sustained and result in real improvements. In addition to gaining support for broad systems and organizational improvement efforts within Customs, the incoming Commissioner will also face the task of gaining acceptance for Customs' trade enforcement strategy from the Congress and the trade community.

Related GAO Products

U.S. Customs Service: Trade Enforcement Activities Impaired by Management Problems (GAO/GGD-92-123, Sept. 24, 1992).

Financial Management: Customs Needs to Establish Adequate Accountability and Control Over Its Resources (GAO/AFMD-92-30, Aug. 25, 1992).

Customs Automation: Cargo Examinations Targeted by Automated Cargo Selectivity System (GAO/IMTEC-89-59, June 27, 1989).

High-Risk Series

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Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

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Defense Weapons Systems Acquisition (GAO/HR-93-7).

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Defense Inventory Management
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(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

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Federal Transit Administration Grant
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December 1992

Defense Weapons Systems Acquisition





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Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

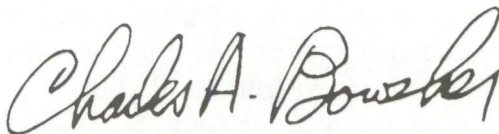
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the Department of Defense's annual expenditure of billions of dollars to acquire new weapons systems. It focuses on weaknesses in the way major weapons requirements are determined, planned, budgeted, and acquired. The report addresses process, procedural, and internal control weaknesses, as well as underlying conditions and cultural attitudes that help foster these weaknesses. These issues are addressed in more detail in our report Weapons Acquisition: A Rare Opportunity for Lasting Change (GAO/NSIAD-93-15).

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Defense.



Charles A. Bowsher

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Overview

The Department of Defense (DOD) spends billions of dollars each year developing and procuring major weapons systems. These expenditures have produced many of the world's most technologically advanced and capable weapon systems—as demonstrated during Operation Desert Storm. Nevertheless, the process through which weapons requirements are determined and systems acquired has often proved costly and inefficient—if not wasteful. In addition, the “high stakes” weapons acquisition process has proven vulnerable to fraud, waste, and abuse. It was this high stakes process—and the absence of adequate internal controls—that provided the breeding ground for the investigation and charges of influence-peddling known as “Ill Wind.”

DOD has made some improvements in the weapons acquisition process over the years. Major reforms recommended by the President's Blue Ribbon Commission on Defense Management—the Packard Commission—in 1986 have been or are currently being implemented. In addition, the diminished Soviet threat and corresponding budget reductions are also prompting major changes in the way DOD acquires weapons systems. Top management

within the Office of the Secretary of Defense has taken steps in an attempt to make the acquisition process more disciplined and to redefine the basic strategy for acquiring weapons. Moreover, key Members of Congress are calling for the military services to reevaluate their roles and functions.

The Problem

Despite many efforts to reform and improve DOD's weapons acquisition process over the years, a number of fundamental problems persist. For example, despite an increased emphasis on the sound development and testing of weapons, we still see major commitments to programs, such as the B-2 bomber and the Airborne Self-Protection Jammer, without first seeing proof that these systems will meet critical performance requirements. Despite improved cost-estimating policies and procedures, we still see the unit costs of weapon systems, such as the DDG-51 destroyer and the C-17 transport, double. Despite the increased emphasis on developing systems that can be efficiently produced and supported, we have weapons, such as the Advanced Cruise Missile and the Apache helicopter, that still encounter costly production and support problems.

Clearly, problems are to be expected in major weapons acquisitions, given the technical risks and complexities involved, but too often we find

- systems being acquired that may not be the most cost-effective solution to the mission need,
- overly optimistic cost and schedule estimates leading to program instability and cost increases,
- programs that cannot be executed as planned with available funds,
- program acquisition strategies that are unreasonable or risky at best,
- too much being spent before a program is shown to be suitable for production and fielding, and
- individuals seeking to improperly influence the outcome of the contracting process.

The Causes

While there are many reasons for these types of problems, the underlying cause of persistent and fundamental problems in

DOD's weapons acquisition process is a prevailing culture that is dependent on generating and supporting new weapons acquisitions. The culture is made up of powerful incentives and interests that influence and motivate the behaviors of participants in the process. Participants include the various components of the Department of Defense, the Congress, and industry. Sometimes, these interests transcend the need to satisfy the most critical weapons requirements at minimal cost. Such interests may include protecting (1) service roles and missions, (2) service budget levels and shares, (3) service reputations, (4) organizational influence, (5) the industrial base, (6) jobs, and (7) careers.

Collectively, these interests create an environment that encourages "selling" programs—a process that may entail undue optimism, self-interest, and other compromises of good judgment. In this environment, it may not be reasonable to expect program sponsors to present objective risk assessments, report realistic cost estimates, or perform thorough tests of prototypes when such measures may expose programs to disruption, deferral, or even cancellation.

The “culture” is not the cause of all the problems in weapons acquisitions. Some problems can be attributed to basic errors in judgment or other motivating forces. For example, the “high stakes”—that is, the big money involved—in defense acquisitions can lead to influence-peddling and contracting fraud and abuse—as found in the “Ill Wind” investigation.

**GAO’s
Suggestions for
Improvement**

If changes in the acquisition of weapons are to be of a lasting nature, they must be directed at the system of incentives that has become self-sustaining and very difficult to dislodge. Incentives and opportunities that produce undesirable behaviors must be eliminated or minimized through effective internal controls and/or offset by stronger—positive or negative—incentives. Moreover, officials in top DOD management positions, as well as the acquisition work force in general, must be held to the highest standards of integrity and conduct. Specific suggestions for addressing several prevalent undesirable behaviors or conditions are described below.

**Controlling
Inter-Service
Competition**

Several actions are needed to change incentives and conditions leading to

inter-service competition, self-interest, and the acquisition of unnecessary, overlapping, or duplicative capabilities. These actions could also reduce incentives for overselling programs. First, a consensus must be reached between the Congress and the administration on military strategy, the services' roles and missions, and future funding levels. Uncertainty surrounding current roles and missions encourages the services to acquire weapons that will support and protect traditional or desired capabilities. The inability of DOD to accurately predict outyear funding levels has resulted in optimistic spending plans that cannot be executed under actual funding levels.

Secondly, determining needed capabilities and the particular types of weapons to fill those needs should not be left with individual branches and warfare communities within the services. The duplicative outcomes of the acquisition process are an outgrowth of the fact that system requirements mirror the traditions and self-preservation instincts of their sponsoring organizations. Making these decisions at the Office of the Secretary of Defense level could enable competing demands, available resources, and the needs

of theater commanders to be more fairly assessed before a specific program is given life.

Discouraging the
Overselling of
Programs

A combination of internal controls and other forms of incentives and disincentives is needed to reduce the tendency to sell weapons programs through optimistic cost and schedule estimates and accelerated—and therefore, high risk—acquisition strategies. Under the existing culture, the success of participants' careers is more dependent on getting programs through the process than on achieving better program outcomes. Accordingly, overselling “works” in the sense that programs get started, funded, and eventually fielded. The fact that a given program costs more than estimated, takes longer to field, and does not perform as promised is secondary to getting a “new and improved” system to the field.

Limiting Technology
Risks

Research and technology efforts need to be freed from program association until they mature to a specified level, such as the demonstration and validation phase. This idea is already embodied in DOD's new acquisition strategy, which calls for advanced technologies to prove their

feasibility and producibility before they are incorporated into new or ongoing acquisition programs.

Limiting
Opportunities for
Fraud and Abuse

DOD must continuously review and ensure compliance with controls designed to (1) ensure the free flow of current and accurate information from the contractors and program offices to top decisionmakers and those with oversight responsibility and (2) prevent improper influencing of contract awards.

Today, the prospects for constructive change are quite encouraging. The demise of the Soviet threat and declines in defense budgets have created a unique opportunity to effect lasting changes in the weapons acquisition process. Both the Department of Defense and the Congress have acted upon this opportunity and have shown a willingness to support the types of changes needed to improve acquisition outcomes. DOD must ensure that effective internal controls are in place to minimize cultural influences, incentives, and behaviors that are not in the best interest of the taxpayers.

Persistent Problems in Weapons Acquisition

Despite conscious attempts to improve the acquisition process, weapons still cost more, take longer to field, often encounter performance problems, and, in many instances, are difficult to produce or support. The persistence of these problems reflects the fact that the design, development, and production of major weapon systems are extremely complex technical processes that must operate within equally complex budget and political processes. If a program is not well conceived, planned, managed, funded, and supported, problems such as cost growth, schedule delays, and performance shortfalls can easily result. Even properly run programs can experience problems that arise from unknowns, such as technical obstacles and changes in the threat. In short, it takes a myriad of things to go right for a program to be successful, but only a few things to go wrong to cause major problems.

On the basis of our experience in reviewing weapons programs over the years, we have noted that vulnerability to major problems can usually be associated with decisions or determinations made in answering the following five key questions as weapon systems proceed through the acquisition cycle:

- Is the system the best solution to the mission need?
- Are the program cost and schedule estimates reasonable?
- Can the program be executed with available funds?
- Is the program's acquisition strategy reasonable?
- Is the system suitable for production and fielding?

**Is the System the
Best Solution to
the Mission
Need?**

DOD acquisition policies require analyses of missions, mission needs, costs, and alternatives to ensure that cost-effective solutions are matched to valid needs before substantial resources are committed to a particular program. An important objective is to minimize overlap and duplication among weapon systems that perform the same or similar missions. This is of particular concern when more than one service participates in similar mission areas. We have found that, while the services conduct considerable analyses in justifying major acquisitions, these analyses can be narrowly focused, not fully considering

alternative solutions, including the joint acquisition of systems with the other services.

The consideration of alternatives to the Air Force's \$3.5 billion Sensor Fuzed Weapon program is an example of the narrow focus of some of these analyses. In an August 1991 report, we discussed the Air Force's plans to use the Sensor Fused Weapon primarily to interdict enemy follow-on forces before they could reinforce or replace troops at the front lines. We found that the Air Force's cost and operational effectiveness analysis had not considered the full range of weapons available. Weapons such as Air Force mines and Army surface-to-surface and air-to-surface missiles and rocket systems were excluded. DOD said the Army systems had not been considered appropriate for inclusion in the analysis because each service had a valid, complementary requirement to engage enemy targets and should procure weapons to kill those targets. We believe such a policy enables the services to pursue their own solutions regardless of what the other services are doing, unnecessarily increasing DOD's development, production, and support costs.

Similarly, in April 1992, we reported on DOD's determination of weapon system requirements for its close support mission. Again, we found that Air Force and Army analyses of alternatives to satisfy their mission needs have been limited to specific types of weapons within their purview. The analyses gave little, if any, consideration to the contributions of other close support weapons, especially those from another service branch.

Are the Program
Cost and
Schedule
Estimates
Reasonable?

Cost growth and schedule delays, two of the most prevalent acquisition problems, are also among the oldest and most visible problems associated with weapon systems. Program cost increases on the order of 20 to 40 percent have been common on major weapon programs, with numerous programs experiencing increases much greater than that. These increases become more telling when translated into unit costs. For example, the estimated unit cost of the Comanche helicopter has more than doubled since May 1985. Similarly, schedule delays are experienced on almost every program, with the accumulation of delays on some adding up to 4 or more years.

The desire of program sponsors to keep cost estimates as low as possible and to present attractive milestone schedules has encouraged the use of unreasonable assumptions about the pace and magnitude of the technical effort, material costs, production rates, savings from competition, and other factors. In some cases, acquisition cost estimates have been kept low by excluding relevant program costs—such as the cost of training equipment—which should be included in program cost estimates. Moreover, cost and schedule estimates are interdependent. A schedule delay, assuming program scope is not reduced, will likely drive program cost up.

Program cost increases and schedule delays are often the manifestation of other problems with a program. For example, it takes additional time and money to accommodate an expansion in program scope, to overcome technical or production problems, and to restructure a program to absorb funding reductions. On the other hand, cost and schedule problems often result from flaws within the estimates themselves.

We have reported on cost and schedule problems many times over the last 15 years.

Our September 1991 report on missile acquisition programs provides a good synopsis of these problems. We reviewed the 12 DOD missile systems in production that had at least 5 years of production experience. Each had encountered cost and schedule overruns, with the unit acquisition cost for 9 of the 12 having increased 20 percent or more over the planning estimates. A detailed examination of eight systems found that the unit cost and schedule planning estimates were often overly optimistic, not adequately reflecting the risks associated with the missile system's design, development, and production. Costs grew and delays occurred, reflecting the increased technological development required and the greater-than-anticipated complexity of the production processes.

Can the Program
Be Executed With
Available Funds?

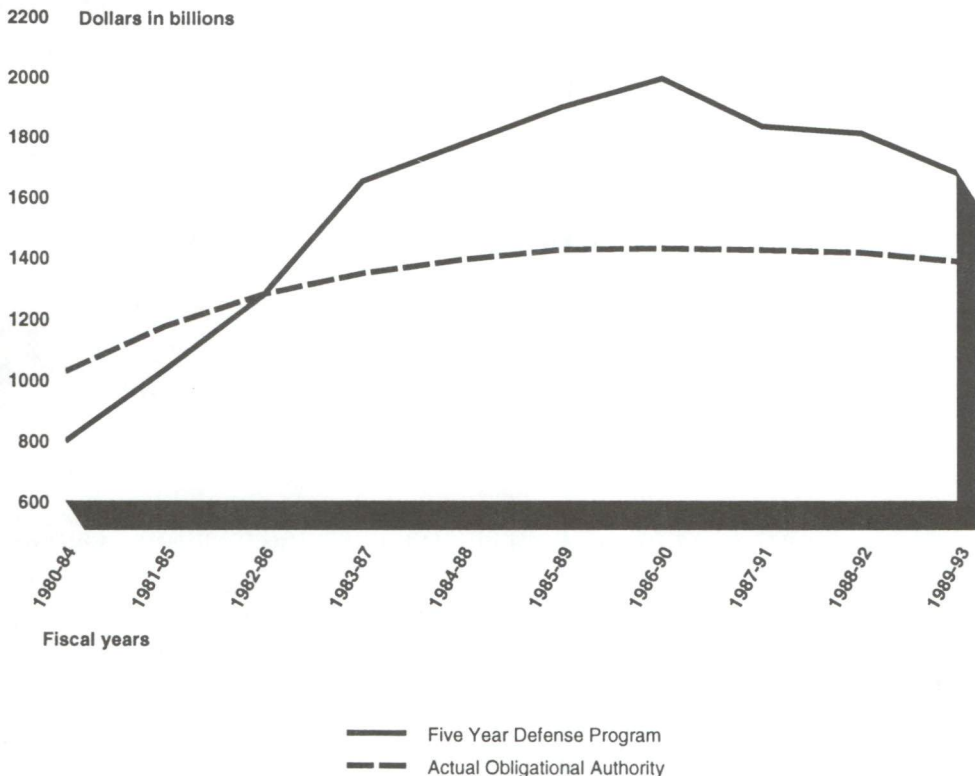
DOD's tendency to overestimate the amount of future funding available for defense, coupled with the tendency to underestimate program costs, has resulted in more programs being started than can be executed intact—"too many weapon systems chasing too few dollars."

We have reported and testified on what we call DOD's planning/reality mismatch. We

have noted that DOD's 5-year spending plan for 1986-90 was about \$553 billion more than what was ultimately funded. The 5-year plans, based on the assumption that real funding growth in the outyears would continue, showed that DOD was able to afford "on paper" the cost of developing and producing all the weapons in the pipeline at optimum and efficient rates. In other words, program managers were making development and production plans and schedules based on funding levels that ultimately would not be realized. When DOD was finally faced with funding reality, it often reduced, delayed, and/or stretched out programs—adding millions of dollars to their costs. Figure 1 shows the gaps between DOD's 5-year plan and funding realities beginning with the 1982-86 Five Year Defense Program.

Persistent Problems in Weapons Acquisition

Figure 1: Mismatch Between DOD's Planning and Budget Realities



Although in recent years DOD has made significant progress in reducing this gap, the spending plans have still not been able to keep pace with the rapid changes in the national security environment. DOD is now required by law to ensure that its spending plans and the President's budget match.

However, we have reported that planned spending levels contain billions of dollars in savings and reductions that may not fully materialize. These include (1) higher costs and less savings than expected from base closures and other activities, (2) less savings than expected from the Defense Management Report initiatives, and (3) less savings than expected from the proposed termination of some major programs that Congress continues to fund. Another important factor in the affordability equation not captured in figure 1 is the widening effect that unplanned cost growth in weapon programs has on the funding mismatch. That is, if program costs were reasonably estimated and the pace and quantities called for in the individual program plans were not changed, the demand for funds would actually exceed the levels currently projected in DOD's program plans. Thus, cost growth will still provoke an affordability problem, even if funding projections are reasonable. Further, it appears that the Congress intends to fund less than the planned amounts in the current spending plan, thereby continuing the gap between proposed and actual funding amounts.

Is the Program's
Acquisition
Strategy
Reasonable?

The acquisition strategy, which is a comprehensive plan of how to achieve the weapon system program's goals and objectives, is a major determinant of program outcomes. It is the service's plan for developing, fielding, and supporting a weapon, including the managerial, technical, and contractual approaches. A key element of the strategy is the program schedule, which is punctuated by major events such as testing and key decision points. The two most basic demands an acquisition strategy must meet are inherently conflicting—developing and fielding the weapon as quickly as possible to counter the threat, while minimizing technical and cost risks. A strategy optimized for accelerated fielding will likely accept higher risk primarily through concurrent development and production. Under such a strategy, major problems are more likely to be discovered in production, when it is either too late or very costly to correct them. On the other hand, a strategy optimized for risk aversion will result in a prolonged development schedule and increased developmental costs.

We have found that in striking these compromises, acquisition strategies embody optimistic assumptions regarding the difficulty of the technical effort; the outcome

and timing of key events, such as testing; and, as discussed earlier, the cost, schedule, and affordability of the effort. The inevitable result has been acquisition strategies that are tightly strung, being both sensitive and susceptible to perturbations such as funding reductions and unanticipated technical problems.

Concurrency in the
Acquisition Process

Perhaps the most troublesome characteristic of acquisition strategies in the 1970s and 1980s was the high degree of concurrency between the development and production of weapons. "Concurrency" can be broadly defined as the practice of beginning production before completing development, testing, and evaluation. Concurrency can be used to expedite the acquisition and deployment of weapon systems, and a certain amount of it can make good management sense. For example, proving out critical production technologies in development can avert major problems in production. However, the reason most commonly cited for using a concurrent acquisition strategy has been to expedite development and production so the weapon can be fielded quickly to counter the Soviet threat. Concurrency is also used to absorb delays caused by cost, funding, technical, or

other problems. Such an approach increases program risk, particularly when complex or novel technologies are involved.

At the very least, a highly concurrent strategy forces decisionmakers to make key decisions without adequate information about the weapon's demonstrated operational effectiveness, reliability, logistic supportability, and readiness for production. Also, rushing into production before critical tests have been successfully completed has resulted in the purchase of systems that do not perform as intended. These premature purchases have affected the operational readiness of our forces and have quite often led to expensive modifications. Among the most celebrated examples of excessive concurrency are the C-5A cargo aircraft and the B-1B bomber programs. The C-5A entered production before the aircraft was fully tested, which led to a 12-year wing modification program costing about \$1.3 billion to correct problems. On the B-1B, full-scale development and production contracts were awarded on the same day for the aircraft's defensive avionics system, which has since been plagued with problems that have seriously impaired the aircraft's capability.

When weapon system development and production schedules become more concurrent than planned, the critical function of independent operational test and evaluation often suffers. Such tests are crucial for assessing mission performance before making significant program dollar commitments. In May 1990, we reported that, based on our review of six weapon systems and other audit work, operational test and evaluation results often were not available to support decisions to start production because the military services failed to plan for such testing. In June 1985, we reported on the testing and evaluation of five weapon systems—the Air-Launched Cruise Missile, the B-1B bomber, the Sergeant York air defense gun, the F/A-18 aircraft, and the AGM-88A High Speed Anti-Radiation Missile. We disclosed that DOD had not obtained operational test results on any of the five systems before beginning production. On four of the five weapons we identified negative effects, including expensive retrofits or modifications. The Sergeant York program demonstrated the most extreme consequence. After the Army had spent \$2 billion and produced 64 of the 614 gun systems, the Secretary of Defense terminated the program because operational tests showed that the system was only a

marginal improvement over the existing air defense system.

Even if the operational test and evaluation are timely, methodological shortcomings can inhibit their effectiveness. Common weaknesses in the quality of such testing that we have reported include the lack of realism, independence, and test resources in the planning, execution, and evaluation of the tests. We have also reported on long-standing problems with the completeness and accuracy of test and evaluation reports provided by the services to the Office of the Secretary of Defense and Congress.

Is the System
Suitable for
Production and
Fielding?

Although operational effectiveness problems often attract the most attention, we have found that many weapons encounter significant problems on the production line and in the field. It is DOD's policy to begin planning for production early in the acquisition process to ensure that the weapon system design not only meets performance objectives but also can be produced in an economical and timely manner. Experience, however, has shown that new weapon systems frequently encounter great difficulties as they begin

production. Problems on the production floor commonly result in high unit production costs, late deliveries, high maintenance demands, and poor field reliability. Production cost increases on the order of 50 percent are not unusual and can greatly disrupt funding plans, schedules, and program quantities.

In a May 1985 report, we analyzed the experience of six weapon systems as they made the transition from development to production. We found that, in varying degrees, production preparations, such as producibility studies and manufacturing technology projects, for four of the programs—the Copperhead projectile, Black Hawk helicopter, Tomahawk cruise missile, and High Speed Anti-Radiation Missile programs—had been sporadic and underfunded and had been largely compressed into the late stages of development and early stages of production.

Despite increased recognition by DOD during the 1980s of the importance of addressing producibility in the acquisition process, we have continued to witness production problems on some of the very latest acquisitions, including the B-2 bomber, the

SSN-21 attack submarine, and the Advanced
Cruise Missile.

Operational
Suitability

The technology that has made high-performance weapons possible has also introduced new challenges to weapon system designers to make these weapons suitable for field operations. To be operationally suitable, weapons must, among other things, be able to be effectively operated, maintained, and supported by the military forces. Our reviews have disclosed that design considerations such as reliability, maintainability, and logistics support have been compromised or otherwise not adequately considered during the acquisition process. Performance and schedule requirements tend to take precedence over operational suitability concerns, particularly when funding shortfalls force trade-offs. The result has often been very high maintenance and support costs and lower-than-expected availability for operations.

Although DOD took steps during the 1980s to place increased emphasis on operational suitability considerations during the acquisition process, we continue to witness weapon systems being deployed without reliable support and test equipment or with

design problems that require retrofits and modifications to make them suitable for field use. Examples include the Apache helicopter, the Advanced Medium Range Air-to-Air missile, and various electronic warfare systems, including their test equipment.

Fraud and Abuse in Contracting

The investigation and charges known as “Ill Wind,” involving influence-peddling, bribery, and fraud, provided a startling reminder that, despite years of reforms and efforts to minimize the risk of such activity, the vulnerability to such activities is present whenever powerful incentives and opportunities for these behaviors exist.

Vulnerability to contract fraud and abuse is high in basically two areas. The first area is overpriced defense contracts, which cost the taxpayer billions of dollars more than necessary. Overpricing practices include contractors’ (1) failing to provide DOD with accurate, complete, and current cost or pricing data at the time of negotiations (producing what is called “defective” pricing) and (2) using inadequate methods to estimate costs. This vulnerability is addressed in a separate high-risk series report entitled Defense Contract Pricing (GAO/HR-93-8).

Improperly influencing the outcome of the contracting process is the second area of contracting vulnerability—which was the focus of the “Ill Wind” investigation. The investigation involved search warrants and more than 250 subpoenas for documents and evidence on the activities of over 50 private

consultants and more than a dozen defense companies and industry executives, as well as DOD officials. Convictions that resulted from the investigation included those of (1) a high-ranking DOD official for selling his influence for bribes and leaking government information to defense firms bidding on weapons contracts, (2) a consultant for arranging bribery payments to two DOD officials, and (3) a large corporation for bribing government officials and conspiring to defraud the United States.

A November 1991 congressional report entitled Management Reform: A Top Priority for the Federal Executive Branch identified a number of specific issues related to the adequacy of existing procurement practices and the lack of a management capability to address the procurement problem. These included (1) a high dependency on the use of consultants to write specifications, prepare cost estimates, and even monitor other contractors; (2) a highly competitive contracting environment, which created a frantic market for inside information; (3) the lack of properly trained government personnel; and (4) "revolving door" opportunities for government personnel to obtain employment with contractors with which they worked.

Despite the overall high integrity, ethics, and professionalism of the defense acquisition work force and those who manage it, the opportunity and incentives for fraud and abuse are ever present. In the current high-stakes, highly competitive environment of shrinking defense expenditures, the outcome of a major contract award can often determine the continued survival of a company. Such high stakes increase the incentive for improper conduct. Also, streamlining efforts are placing greater decisionmaking responsibility on individuals and eliminating layers of review and oversight. While such streamlining efforts are beneficial and necessary, it is important not to overlook the value of internal controls.

Conclusions and Action Needed

The Groundwork for Cultural Change

The opportunity afforded by the dissolution of the Soviet threat opens the door to making needed changes; declining defense budgets demand them. By themselves, however, even these compelling reasons may not be enough to uproot an acquisition culture whose system of incentives has become self-sustaining. Acquisition participants hold the key to cultural change since they largely determine the motives and incentives of the acquisition process.

The defense acquisition decisions made over the next few years will be especially critical because they are intertwined with the rewriting of national security policy and military strategy. Decisions on next-generation weapons will define solutions to defense policy needs, dictate budgets for the remainder of the decade, and, in the process, either take advantage of or miss the opportunity to improve the acquisition culture.

While DOD has revised the military strategy, congressional debate on issues such as roles and missions suggests that a consensus has not been reached. Long-term dividends could result if the Congress and the administration refrain from making weapon system milestone decisions until they agree on a

military strategy, including how and where U.S. forces should be prepared to fight; how the forces should be structured to accomplish national security objectives; and how to preserve the research, technology, and industrial base. These should be explicit choices; they should neither be dictated by individual program decisions, nor be the tenuous byproduct of budget compromises. With an agreed-upon strategy, consensus on the roles and missions of the services could be more easily reached, and weapon programs could then be the result of clear decisions on how to implement policy, rather than the result of incremental decisions that address individual interests.

If changes in the acquisition of weapons are to be of a lasting nature, they must be directed at the system of incentives that has become self-sustaining and very difficult to uproot. Incentives and opportunities that produce undesirable behaviors must be minimized or eliminated through effective internal controls and/or offset by stronger—positive or negative—incentives. Specific suggestions for addressing key undesirable behaviors include (1) elevating authority for determining weapons priorities, (2) defusing the need to oversell programs on the basis of performance and urgency,

(3) reducing technological risks prior to incorporating research efforts into specific weapons development programs, (4) discouraging unrealistic cost estimates, and (5) aligning career success with better program outcomes.

Authority for
Determining
Program Needs

To reduce the narrow service self-interest currently inherent in program justifications, the authority for determining needed capabilities and the particular types of weapons to fill those needs should not be left with individual branches and warfare communities within the services. The duplicative outcomes of the acquisition process are consistent with the fact that system requirements mirror the traditions and self-preservation instincts of their sponsoring organizations. Moving this authority higher up in the DOD organization could enable competing demands, available resources, and the needs of theater commanders to be more fairly assessed before a specific program need is given life.

There appears to be a misunderstanding that such authority is currently being exercised by the Joint Requirements Oversight Council (JROC) and/or the Defense Acquisition Board (DAB). The JROC, which must review, approve,

and revalidate each major weapon requirement before the weapon can proceed to the next stage in the acquisition process, has revalidated every weapon system requirement it has reviewed since 1989.

The DAB, which conducts milestone reviews of weapons programs at each stage of the acquisition process, has taken a limited role in managing overall weapons acquisition, requirements, and affordability. Despite major changes in threat and reductions in defense spending, the DAB has approved every program to proceed to the next acquisition stage since January 1990.

There is not necessarily a "right" answer to the question of where the authority for determining program needs should be vested. Possibilities include the Defense Planning and Resources Board, which was established to help develop stronger links between national policies and the resources allocated to specific programs and forces; the Office of the Secretary of Defense; or perhaps a high-level council/board within each service, following any realignment of their roles and missions.

It is also important that if a debate is to occur between DOD and the Congress over

the need for a weapon, it should occur early in the process, before the weapon gains too much momentum.

Defusing the Need to Oversell Programs on the Basis of Top Performance and Urgency

The dissolution of the Soviet Union, together with the current U.S. inventories of highly capable weapons, presents opportunities to abate the need to oversell weapon programs, the associated optimism in cost and schedule, and the tendency to weaken acquisition strategies in favor of schedule acceleration or preservation. DOD has made several proposals along these lines, including limiting or terminating production plans for several major weapon systems and reducing concurrency in new programs. However, these changes will not necessarily produce better program outcomes if overselling performance and urgency still “work” in gaining program approval. Defusing the need to oversell programs on the basis of performance and urgency will require decisionmakers to ensure that their decisions on individual programs are consistent with military strategies, policies, and funding levels agreed upon by the administration and the Congress.

When to Define Programs

Carrying research and development efforts further before incorporating them into specific weapon programs could reduce the tendency to overpromise expected results. Weapons programs have traditionally relied on risky technology development efforts. Such efforts, when drawn into a major program, not only become dedicated to the program but are subjected to the same requirements for precise cost and schedule estimates, even though their immaturity defies such precision.

Freeing research and technology efforts from program association until they mature to a specified level, such as the demonstration and validation phase, could be one element of an overall strategy to ensure that the nation nurtures a healthy research and technology base in the face of declining weapons production. Given sufficient funding, the efforts themselves would benefit because they would be more able to explore the full range of results, rather than being directed toward meeting program-specific goals. Under these circumstances, testing could assume a "no fault" nature, whereby its main and proper purpose would be to gauge and guide the progress of the work. In this arena, test failures, problems, and redesigns would be

part of a healthy process, whereas the same results now represent potential disasters in major programs.

When the need for a major program is determined, the program could pick from mature research and technology projects, reducing the subsequent risks to the program. In addition, the testing of a major weapon could then be more properly focused on “how well” it performs, rather than on “whether” it will perform. Many of these ideas are already embodied in DOD’s new acquisition strategy, which calls for greater demonstration of advanced technologies, to prove their feasibility and producibility, before incorporating them into new or ongoing acquisition programs. The success of this strategy will depend on the cooperation of all acquisition participants.

Financial Realism

In weapon acquisitions, optimistic cost estimates are rewarded because they help gain program approval, win contract awards, and attract budgetary income. The consequences of cost growth are not directly felt by an individual program because they are “accommodated” through stretch-outs and quantity changes and by spreading the pain across many programs.

To discourage unrealistic cost estimates, the consequences should be tied back to the program at hand. Such incentives could work the other way as well—programs that are well-managed within estimates should be undisturbed and should keep at least a portion of any cost savings they can achieve.

The Future Years Defense Program can be used as a tool to help decide how much money can be afforded for an individual program and to confront the consequences of program cost growth. The Future Years Defense Program could force the arrangement of programs so they fall within reasonable funding levels. The timing of major programs could be staggered to reflect financial realities. Without some actions along these lines, DOD could, in the future, be faced with a financial “bow wave” of next-generation weapons—a condition that can bring out the worst in acquisition management. The funding plan could also serve to discourage other sources of program cost growth, including requirements increases and program redirections. When any participant—including the Congress—proposes an action that will change the funding profile or timing of a program, that participant should also

propose the trade-offs in the plan that will make the action fiscally possible.

Aligning Career
Success With Better
Program Outcomes

One of the aspects of the acquisition culture that will be most difficult to change is the fact that the success of participants' careers is more dependent on getting programs through the process than on achieving better program outcomes. The success of cultural change will depend on whether participants are rewarded for taking actions that produce better outcomes. It is possible that program managers' careers could be aligned with better outcomes if their progression is governed by the quality of their management and not by the survival of their programs.

At this point, perhaps the most important step participants can take is to recognize the broader implications of their individual actions. In July 1992, the Chairman of the Senate Armed Services Committee called for an overhaul of military roles and missions. To make the difficult choices necessary in such an overhaul, he suggested that the standard should be "what is best for America," not what is best for the individual services. This standard should govern the actions of participants at all levels in the weapons acquisition process.

Effective Controls and High Work Force Integrity Are Keys to Combating Contracting Fraud and Abuse

Establishing and maintaining effective internal controls are essential to minimizing the opportunity for improper conduct on the part of both government and contractor officials. While adequate control mechanisms are often in place, their effectiveness can quickly erode without a sustained commitment to adhering to and enforcing existing controls. Such erosion invites circumvention and opens the door to fraud and abuse.

As DOD continues down the path of downsizing and streamlining its operations, as it must, we caution that due consideration must be given to ensuring that the necessary internal controls and oversight are not lost in the process. Moreover, the key ingredient to combating fraud and abuse is maintaining a high degree of professionalism and integrity in the work force. In 1990, Congress enacted the Defense Acquisition Workforce Improvement Act, which is designed to improve the overall training, education, and experience of the acquisition work force.

A commitment to establishing and maintaining a high degree of professionalism and integrity will be necessary as DOD continues to streamline and downsize its operations. The effect of such actions will be

to place ever increasing reliance on the sound judgment of individuals.

The Prospects for
Change Are
Encouraging

We believe that the top management in the Office of the Secretary of Defense and the Joint Chiefs of Staff has displayed the ability and conviction to forge significant change. They have also done much to reestablish central management of weapon acquisitions. In addition to DOD's recent reform initiatives, these characteristics have been manifested in a number of ways, including

- the strong collective leadership of the Secretary of Defense and the Chairman of the Joint Chiefs of Staff during Operation Desert Storm;
- DOD's proposal to trade off weapon programs in favor of military personnel in an effort to make an orderly transition to a smaller force;
- more realistic funding projections, coupled with an announced firm stand not to allow programs to proceed if they are shown to be unaffordable in the future; and
- renewed commitment to the Packard Commission's recommendations and to

improving the quality and professionalism of the acquisition work force.

The Congress has also taken constructive actions and made proposals to improve weapon acquisitions. For example, the Joint Chiefs of Staff was strengthened by the Goldwater-Nichols Act, enabling it to function more effectively in situations such as Operation Desert Storm. Both the Senate and House Armed Services Committees have been forthright in highlighting the need for a new military strategy in light of the reduced threat and have put forth proposals on such a strategy. The Senate Armed Services Committee has pioneered efforts to authorize funding for entire acquisition phases, so as to reduce program instability. More recently, Members of Congress have proposed renewed emphasis on the “fly before buy” policy in weapon programs and have enacted the Defense Acquisition Workforce Improvement Act to improve the quality of the work force.

Today, the ingredients for making lasting improvements to weapons acquisitions—the need, the opportunity, and the leadership—exist. To convert these ingredients into constructive change will require both the Congress and the

administration to take joint ownership of repetitive acquisition problems and to take explicit steps to resolve them. The actions already under way are important to better outcomes. Also important, in our view, is the recognition of the cultural dimension of acquisition problems and the solutions it suggests. Beyond directives and controls, acquisition participants will have to pull together to make better outcomes the more natural products of a healthier acquisition culture.

Related GAO Products

Weapons Acquisition: A Rare Opportunity For Lasting Change (GAO/NSIAD-93-15, forthcoming).

Electronic Warfare: Established Criteria Not Met for ASPJ Production (GAO/NSIAD-92-103, Mar. 23, 1992).

Electronic Warfare: Radar Jammer Proliferation Continues (GAO/NSIAD-92-83, Feb. 28, 1992).

Tactical Missile Acquisitions: Understated Technical Risks Leading to Cost and Schedule Overruns (GAO/NSIAD-91-280, Sept. 17, 1991).

Acquisition Reform: Implementing Defense Management Review Initiatives (GAO/NSIAD-91-269, Aug. 8, 1991).

Defense Planning and Budgeting: Effects of Rapid Changes in National Security Environment (GAO/NSIAD-91-56, Feb. 5, 1991).

Aircraft Development: Reasons for Cost Growth on the Advanced Tactical Fighter Program (GAO/NSIAD-91-138, Feb. 1, 1991).

A-12: Costs and Requirements (GAO/NSIAD-91-98, Dec. 31, 1990).

Related GAO Products

T-45 Training System: Navy Should Reduce Risks Before Procuring More Aircraft
(GAO/NSIAD-91-46, Dec. 14, 1990).

Defense Management: Efforts to Streamline the Acquisition Management Structure
(GAO/NSIAD-91-15, Dec. 5, 1990).

Acquisition Reform: Authority Delegated to the Under Secretary of Defense for Acquisition (GAO/NSIAD-90-183, June 6, 1990).

High-Risk Series

Lending and Insuring Issues

Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1).

Guaranteed Student Loans (GAO/HR-93-2).

Bank Insurance Fund (GAO/HR-93-3).

Resolution Trust Corporation (GAO/HR-93-4).

Pension Benefit Guaranty Corporation
(GAO/HR-93-5).

Medicare Claims (GAO/HR-93-6).

Contracting Issues

Defense Weapons Systems Acquisition
(GAO/HR-93-7).

Defense Contract Pricing (GAO/HR-93-8).

Department of Energy Contract Management
(GAO/HR-93-9).

Superfund Program Management
(GAO/HR-93-10).

NASA Contract Management (GAO/HR-93-11).

Accountability
Issues

Defense Inventory Management
(GAO/HR-93-12).

Internal Revenue Service Receivables
(GAO/HR-93-13).

Managing the Customs Service (GAO/HR-93-14).

Management of Overseas Real Property
(GAO/HR-93-15).

Federal Transit Administration Grant
Management (GAO/HR-93-16).

Asset Forfeiture Programs (GAO/HR-93-17).

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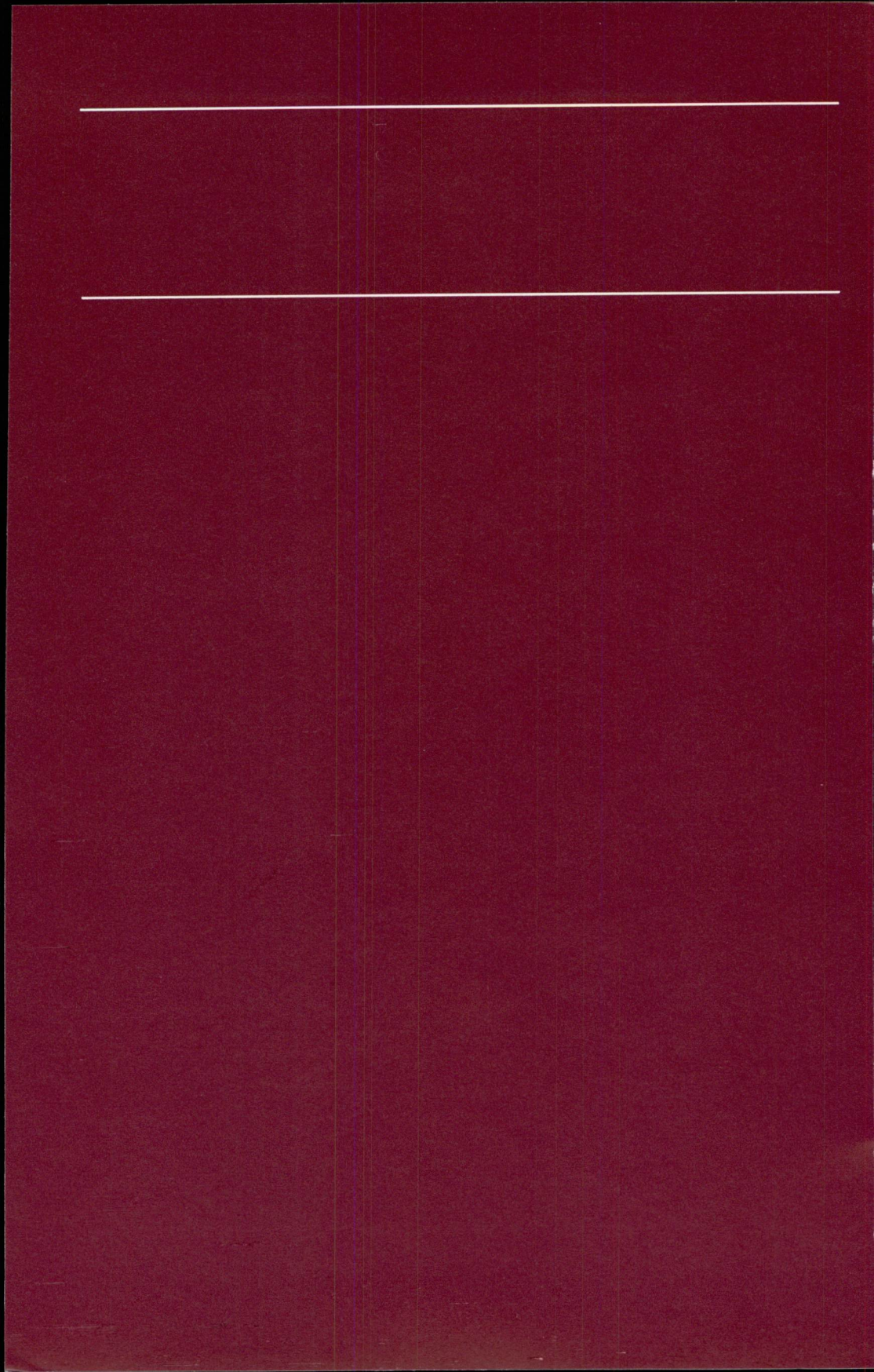
GAO

United States General Accounting Office
High-Risk Series

December 1992

Defense Contract Pricing







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Comptroller General
of the United States

December 1992

The President of the Senate
The Speaker of the House of Representatives

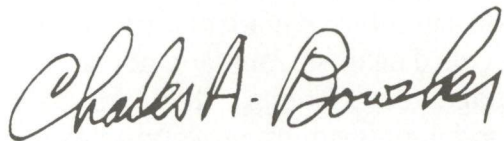
In January 1990, in the aftermath of scandals at the Departments of Defense and Housing and Urban Development, the General Accounting Office began a special effort to review and report on federal government program areas that we considered "high risk."

After consulting with congressional leaders, GAO sought, first, to identify areas that are especially vulnerable to waste, fraud, abuse, and mismanagement. We then began work to see whether we could find the fundamental causes of problems in these high-risk areas and recommend solutions to the Congress and executive branch administrators.

We identified 17 federal program areas as the focus of our project. These program areas were selected because they had weaknesses in internal controls (procedures necessary to guard against fraud and abuse) or in financial management systems (which are essential to promoting good management, preventing waste, and ensuring accountability). Correcting these problems is essential to safeguarding scarce resources and ensuring their efficient and effective use on behalf of the American taxpayer.

This report is one of the high-risk series reports, which summarize our findings and recommendations. It describes our concerns over the significant risks the Department of Defense (DOD) faces as a result of overpriced contracts. The report concludes that, despite the existence of laws and regulations designed to protect the government, the overpricing of defense contracts remains both significant and widespread and costs the taxpayer billions of dollars. While DOD has taken steps to address some problems with overpricing, other serious problems remain. Unless these problems are resolved, DOD can expect continued contract overpricing—something it cannot afford.

Copies of this report are being sent to the President-elect, the Democratic and Republican leadership of the Congress, congressional committee and subcommittee chairs and ranking minority members, the Director-designate of the Office of Management and Budget, and the Secretary-designate of Defense.



Charles A. Bowsher

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Overview

In fiscal year 1991, the Department of Defense (DOD) reported spending almost \$150 billion contracting for goods and services—nearly two and a half times the combined purchases of all federal civilian agencies. Even though defense spending is expected to decrease, contracting costs are not expected to fall below \$100 billion over the next several years.

A substantial share of these expenditures involve negotiations between DOD and contractors. In an attempt to ensure that contractors offer fair and reasonable prices, the law requires that they provide the government with cost or pricing data to support their proposed prices and to certify that this information is accurate, complete, and current. DOD regulations also require major contractors to employ sound cost-estimating systems. DOD has the tools to enforce contractors' compliance with these and other legislative and regulatory requirements and in some overpricing cases can adjust contract prices. Additional tools include imposing monetary penalties, reducing or withholding progress payments, or deciding not to contract further with contractors who break the rules.

The Problem

Despite the laws and regulations, overpricing of defense contracts remains significant and widespread, costing the taxpayer billions of dollars more than necessary for the goods and services purchased. Overpricing practices include (1) failing to provide DOD with accurate, complete, and current cost or pricing data at the time of negotiations (producing what is called “defective” pricing) and (2) using inadequate methods to estimate costs.

While the government is at risk for overpricing in prime contracts, it is particularly at risk in subcontracts, where DOD relies heavily on the prime contractor and the quality of its cost-estimating system to ensure reasonable subcontract prices. Subcontracts frequently account for more than 50 percent of a contract’s costs.

A limited number of contractors account for the majority of reported defective pricing. For example, for fiscal years 1987-91, about 6 percent of the contractors audited accounted for about 80 percent of the defective pricing dollars reported by the Defense Contract Audit Agency (DCAA).

The Causes

DOD has taken some steps to address contract overpricing problems, but serious shortcomings remain. Specifically, (1) contractors' cost-estimating systems are often inadequate, (2) oversight by DOD is too little and too late, and (3) the application of monetary and other penalties is insufficient to change contractors' behavior in any meaningful way.

GAO's Suggestions for Improvement

While we have suggested legislative and regulatory improvements in DOD contracting practices, reducing overpricing problems is less a matter of creating new laws and regulations than of better enforcing those already in place. Without effective enforcement, contractors have a strong incentive to avoid compliance. If negotiated costs are inflated, so too are contractor profits. The following steps would strengthen contractors' incentives to follow the rules.

First, when defense contractors do not provide accurate, complete, and current data to the government or when they do not apply the internal controls that would enable them to do so, the government should use the full range of available tools to enforce compliance. When contractors repeatedly

overcharge the government or fail to act aggressively to correct contract pricing deficiencies, DOD should reduce or suspend their progress payments or decline to award them additional business.

Second, contracting officers and other government officials involved in the contracting process have a responsibility to protect the government's interests. They should be provided with the resources to do their jobs effectively and should be held fully accountable for the results.

Third, although contractors should be allowed to make fair and reasonable profits, they should not receive excessive profits, especially through overpricing. To monitor contractor profits on defense contracts, the Congress should enact legislation requiring the government's contractors to annually report financial data to DOD. If effectively employed, the monitoring of contractors' return on capital and the efficiency of their operations could be used as an alternative to reduce the amount of audit and oversight by DOD on a contract-by-contract or cost-by-cost basis.

Background

Historically, a principal concern in noncompetitive procurements has been how to ensure that the prices proposed by contractors are fair and reasonable. Because of the nature of the contracting process in a noncompetitive environment, both parties—the contractor and the government—attempt to protect their own constituents' interest. The contractors support the shareholder by attempting to maximize profits, while the government protects the taxpayer by trying to ensure that contractors provide quality products at fair and reasonable prices.

Contract overpricing results (1) when contractors do not provide accurate, complete, and current cost or pricing data, as required by the Truth in Negotiations Act, and (2) when contractor cost-estimating systems do not produce reliable contract pricing estimates.

As a result of documented overcharging by defense contractors, the Congress passed the Truth in Negotiations Act in 1962. The act requires contractors and subcontractors to provide the government with cost or pricing data supporting their proposed prices and to certify that the data submitted is accurate, complete, and current. The law

and its added provisions over the years also provided the tools to get contractors to comply by requiring the recovery of amounts determined to be defectively priced plus interest on overpayments and penalties when a contractor knowingly submits defective data. These were major steps forward in achieving a more level negotiating table.

The Department of Defense, after prodding from us and others, also recognized that if contractors were required to provide accurate, complete, and current cost or pricing data, they had to have sound cost-estimating systems to produce this data. At the time, many did not. Thus, in March 1988, DOD changed its regulations to require that major contractors have sound cost-estimating systems.

Even though overpricing resulting from poor estimating may not be recoverable, the regulations did provide for the necessary tools to get contractors to comply. These tools include reducing or withholding progress payments or deciding not to contract with contractors that do not adhere to existing laws and regulations.

Defective Pricing Totals \$3.67 Billion for 5 Years

Despite the existence of laws and regulations designed to protect the government, overpricing of defense contracts remains significant and widespread. Overpricing costs the government billions of dollars, with roughly one of every three audited contracts being identified as defectively priced.¹ During fiscal years 1987-91, the Defense Contract Audit Agency identified defective pricing totaling \$3.67 billion.

While the government is at risk for overpricing in prime contracts, it is particularly at risk for overpricing in subcontracts—subcontract costs frequently represent over 50 percent of a contract's cost. For example, in fiscal year 1991, subcontract defective pricing accounted for \$484 million, or 66 percent, of the defective pricing found by DCAA. Although subcontracts accounted for only 16 percent of the total dollars DCAA examined in fiscal years 1987-91, subcontract defective pricing accounted for 37 percent of the defective pricing found by DCAA during that period.

¹"Defective pricing" occurs when a contract price is increased because the contractor does not provide complete, accurate, and current cost or pricing data. If this happens, the government can reduce the contract price.

**Defective Pricing Totals \$3.67 Billion
for 5 Years**

Overpricing is especially high for a limited number of defense contractors and subcontractors. For fiscal years 1987-91, about 6 percent of the contractors audited accounted for about 80 percent of the defective pricing dollars reported by DCAA. A listing of contractors accounting for large amounts of defective pricing in fiscal years 1990 and 1991 can be found in our report Contract Pricing: A Low Percentage of Contractors Are Responsible for Most Defective Pricing (GAO/NSIAD-93-1).

Poor Cost Estimating by Contractors Adds Millions to Contract Costs

If the government is to achieve fair and reasonable contract prices, it is essential that a contractor have a sound cost-estimating system. Such a system is the principal means by which a contractor develops its proposed contract prices, which form the foundation for contract negotiations. In March 1988, in response to our reports and others, DOD revised its regulations to require major contractors to establish adequate cost-estimating systems. In addition, the revised regulations authorized the contracting officer to take whatever action is determined necessary to ensure that contractors correct identified estimating deficiencies. Such actions include reducing or suspending progress payments and recommending that contracts not be awarded. DOD regulations also require contractors to evaluate subcontract prices and include the results of these evaluations as part of their contract proposals to the government. Such evaluations assist DOD contracting officers in ensuring that only fair and reasonable subcontract estimates are included in contracts.

Despite DOD's efforts to prevent contract overpricing by strengthening its regulations on cost-estimating systems and by increasing its management emphasis on subcontract

pricing, DOD contract prices continue to be overstated because of inflated subcontract estimates. Too often, the real “scrubbing” (detailed review) of subcontract proposals by the prime contractor takes place after the contractor has negotiated with the government. At that point, the prime contractor is frequently able to significantly reduce the subcontract price and retain all or part of the price reduction as windfall profits.

Prime
Contractors
Obtain Price
Reductions on
Competitive
Subcontracts
After Negotiating
With DOD

The DOD requirement for contractors to obtain cost or pricing data supporting subcontractor proposals, to evaluate the data, and to provide the evaluation results to the government as part of their proposals does not apply to subcontracts awarded on the basis of adequate price competition because competition, in large measure, is presumed to produce fair and reasonable prices.

We found, however, that the government did not always receive the full benefits of competition. Contractors, after informing DOD that subcontract estimates were competitively obtained and agreeing on contract prices, obtained lower prices from their prospective subcontractors. For

example, we reviewed 66 subcontracts worth \$44 million whose estimates were identified by a contractor as having been competitively obtained. We found that after “competitively” soliciting subcontract prices to support its proposals to the government, the contractor had resolicited prices and, on 55 of the subcontracts, obtained prices that were \$10.4 million lower than what was proposed and included in the prime contracts. Conversely, the contractor awarded 10 subcontracts at prices that were about \$1.5 million more than what was proposed and negotiated in the prime contracts. Thus, the prime contractor’s actions subsequent to negotiating with the government resulted in a net amount of \$8.9 million less than agreed to with the government. This is not a new issue, and the practice appears widespread.

Prime
Contractors
Award
Noncompetitive
Subcontracts at
Lower Costs

In addition to negotiating lower prices on competitive subcontracts, some prime contractors negotiate substantial price reductions on noncompetitive subcontract proposals after completing negotiations with the government. For example, we examined 12 noncompetitive subcontract estimates, each in excess of \$1 million. We found that in the aggregate, prime contractors had

made awards on these estimates for about \$8.8 million less than the prices negotiated in the contracts with DOD.

As mentioned earlier, overpricing resulting from poor estimating may not be recoverable by the government. So it is absolutely essential that contracting officers' actions to correct contractors' deficient cost-estimating systems are effective and timely.

Inadequate
Government
Oversight
Increases the
Risk of Contract
Overpricing

In addition to requiring sound contractor cost-estimating systems, DOD must have an effective oversight program that (1) identifies and audits contractors that are considered at risk for overpricing and (2) ensures effective and timely action when problems are found. Our reviews have shown that

- DCAA's audit coverage of known high-risk contractors is limited,
- many subcontracts that are subject to being audited for defective pricing are not known to DCAA and thus not evaluated for risk or for overpricing,
- action by some contracting officers to correct contractors' deficient cost-estimating

systems are insufficient, and

- DOD's management information on problem contractors is inaccurate and incomplete.

Increased
Coverage of
Known High Risk
Contracts and
Subcontracts Is
Needed

DCAA is the principal agency for auditing defense contracts. It is responsible for conducting defective pricing audits to determine whether contractors have complied with the Truth in Negotiations Act. DCAA, along with government contract administration personnel, also evaluates the adequacy of contractors' cost-estimating systems.

Because of the large number of contracts and subcontracts that are subject to DCAA audits for defective pricing and the competing demands on its resources, DCAA cannot audit all contracts and subcontracts subject to the Truth in Negotiations Act. As a result, DCAA allocates its audit resources based on its assessment of risk. In assessing risk, DCAA considers, among other factors, the adequacy of contractors' cost-estimating systems and their histories of defective pricing. For example, for high-risk, fixed-price contracts worth under \$10 million each, DCAA's selection criteria for fiscal year 1992 called for it to audit 1 in 15

contracts. For medium-high risk, fixed-price contracts, its selection plan calls for it to audit 1 in 30 contracts worth under \$10 million each. In the past, DCAA has not been able to complete all the audits that its plans call for.

Contract overpricing remains a high-risk area, vulnerable to fraud, waste, and mismanagement. Even though contracting for goods and services will continue to consume over one-third of the defense budget in the near term, we recognize that the post Cold-War reductions will result in fewer contracting actions requiring audits by DCAA. However, in previous reports and testimonies we have cautioned that, because of the significant amount of audit backlog and the constrained coverage in areas such as operational audits and defective pricing, DCAA must have sufficient audit resources and adequate information to ensure that the government's interests are adequately protected. We believe that any reduction in DCAA work load resulting from reduced numbers of contracting actions offers an opportunity to redirect DCAA's staff resources to these other areas of risk.

Many
Subcontracts Are
Not Identified for
Audit
Consideration

In order to allocate its resources to contracts with the highest risk, DCAA must be aware of the universe of both prime contracts and subcontracts subject to audit under the Truth in Negotiations Act. In reviewing a sample of 211 negotiated subcontracts having a dollar value of about \$337 million, we found that DCAA was not aware of 186, or 88 percent, of the subcontracts. The 186 subcontracts were worth about \$189 million, or 56 percent of the total value of subcontracts in our sample.

Unless DCAA knows of all subcontracts subject to audit and assesses the risk of defective pricing on each, it cannot ensure that its audit resources are being appropriately applied to subcontracts with the greatest risk of defective pricing. Also, by not being aware of all subcontracts, DCAA will understate the resources it needs for its defective pricing program. Accurately estimating DCAA's work load and staffing needs is particularly important in today's environment, where DCAA may be required to reduce staffing.

The principal reason that DCAA auditors are not aware of subcontracts is that prime contractors are not required to provide DCAA with lists of subcontracts that are subject to

the Truth in Negotiations Act. The regulations should be changed to require contractors to report this information. We recently recommended that the Secretary of Defense examine the costs and benefits of changing the Defense Federal Acquisition Regulation Supplement to require prime contractors to notify the government of all subcontracts subject to the Truth in Negotiations Act. As an interim measure, we also recommended that the Secretary direct DCAA to require that when offices auditing prime contracts identify subcontract information, they share that information with the DCAA office responsible for auditing the subcontract. DOD is currently taking action to address these recommendations.

Actions by
Contracting
Officers to Obtain
Contractor
Improvements
Are Mixed

Government contracting officers, with DCAA's help, are responsible for determining the adequacy of contractors' cost-estimating systems. When DCAA reports an estimating deficiency, DOD regulations establish procedures and time frames for its correction. If a contractor does not make adequate progress in correcting the deficiency, administrative contracting officers are authorized to take actions to obtain correction, such as reducing or suspending progress payments,

recommending that new contracts not be awarded, or bringing the issue to the attention of higher-level DOD management.

In 1991, we reported that many cost-estimating deficiencies had remained uncorrected for long periods of time despite (1) the 1988 revision in DOD's regulation requiring major contractors to establish adequate cost-estimating systems and (2) DCAA audit reports identifying estimating deficiencies. Some problems remain.

One reason for the slow correction of deficiencies was that DOD administrative contracting officers had taken inadequate actions or had not followed established procedures. For example, some contracting officers considered deficiencies to have been corrected when contractors simply promised to do so. We found that too often, the promised actions had either not been taken or proved inadequate. If DOD is to reduce the risks of overpriced contracts, its contracting officers need to more thoroughly review contractors' actions. When contractors do not act, contracting officers need to use the tools available to them to ensure compliance.

DOD's Follow-Up
System Is
Inaccurate and
Incomplete

DOD's audit follow-up system is a key component of its oversight of contractors with cost-estimating problems. In May 1991, DOD testified that its audit follow-up system provided DOD management with the necessary insight into pricing problems with both prime contractors and subcontractors.

We reviewed DOD's audit follow-up system and found that the system did not provide accurate and complete information on the condition of cost-estimating systems for many high risk contractors. The follow-up system data was inadequate in three areas. The system (1) was missing reports on contractors; (2) understated the length of time cost-estimating deficiencies remained uncorrected; and (3) showed contractors had corrected deficiencies, when our review showed they had not.

DOD has proposed changes or recently taken action to improve its audit follow-up system. While we believe these actions will improve the follow-up system, DOD's administrative contracting officers still need to verify that contractors have corrected all deficiencies cited in DCAA audits of cost-estimating systems before reporting that corrective actions have been completed.

Deterrents Offered by the Truth in Negotiations Act Are Not Used Effectively

For the Truth in Negotiations Act to be a successful deterrent, DOD's implementation of the sanctions provided by the act must sufficiently compel contractors to comply with its requirements. The basic sanction provided by the act is that if defective pricing is found, the contract is to be reduced by the amount of defective pricing. In November 1985, the Congress added provisions to the act requiring contractors to pay (1) the interest on overpayments and (2) a penalty equal to the amount of defective pricing, when they knowingly submit defective data.

Our ongoing review is showing that DOD's enforcement of the act has not served as an effective deterrent because (1) the amount of DCAA-identified defective pricing sustained by DOD is low, (2) the interest on overpayments is not fully collected, and (3) the penalty provision of the law is not used.

Low Sustention Rates

The DOD Inspector General reported that the defective pricing sustention rate for the first half of fiscal year 1992 was 34 percent, down 7 percentage points from fiscal year 1991. Primary reasons for the low sustention rate are that (1) contracting officers negotiate

Deterrents Offered by the Truth in
Negotiations Act Are Not Used
Effectively

with contractors to resolve DCAA-identified defective pricing and settle for significantly reduced amounts rather than assume the litigative risk associated with defending a settlement decision before an independent board of contract appeals and (2) DCAA audits were in error or the facts did not sufficiently support their determinations of overpricing. Further, the bases for many of the settlements were not adequately documented, preventing determinations as to why the reductions from audit findings had occurred. While contracting officers are required to fully consider DCAA's audit findings and to document the disposition of recommendations, they exercise wide latitude in settling audit findings with contractors. We are in the process of more fully identifying the reasons for low sustention rates and pursuing whether there are problems in need of corrective action.

Interest Not Fully
Collected

More interest could be recovered on overpayments. The law provides that interest shall be charged from the date of overpayment to the date of repayment by the contractor. The procurement regulations, however, limit the interest charged to the period from the date a product or service is delivered until the date of repayment—a

Deterrents Offered by the Truth in
Negotiations Act Are Not Used
Effectively

shorter time period because contractors are paid before delivery. In addition, in some cases, contracting officers are inappropriately waiving interest in the negotiation of a settlement with the contractor. With \$731 million of DCAA-identified defective pricing in fiscal year 1991, interest on overpayments can amount to tens of millions of dollars annually.

Penalty
Provisions Not
Exercised

According to DOD, the penalty provision of the act, one of the more significant enforcement tools available to contracting officers, has not been exercised. The act states that a penalty equal to the amount of the defective pricing may be assessed the contractor if the contractor knowingly submitted defective data. However, the penalty provision has not been exercised because contracting officers, as well as other DOD officials, equate the "knowing" determination with civil and criminal fraud. Cases of defective pricing with civil or criminal fraud implications are beyond the contracting officers' authority to settle and are prosecuted by the Department of Justice under the False Claims Act. We noted several cases in which contractors would have avoided submitting the defective data if

**Deterrents Offered by the Truth in
Negotiations Act Are Not Used
Effectively**

established procedures had been followed or the contractors had corrected long-standing problems with their cost-estimating systems. Such cases appear to warrant penalties even if fraud cannot be proven. While the effective use of the penalty provision would result in more dollars being collected, the more significant effect is the enhanced deterrence against future overpricing that would likely be achieved.

Lack of a Financial Reporting System to Ensure Fair and Reasonable Profits

About 10 years ago, segment-level financial data was collected for a DOD study comparing defense contractors' profitability with that of nondefense manufacturers. The study showed that defense firms were earning excessive profits on government contracts. In response, defense contractors stated that doing business with the government was riskier than doing business with nondefense companies, thereby warranting higher profits. Defense contractors pointed out that their stock price/earnings ratios were below market averages, resulting in a higher cost of capital, thereby making it more costly to do business with the government.

Tracking the cost of capital, when compared with the return on that capital, could provide the information needed to determine whether defense contractors are making excessive profits over time. Monitoring this measure, along with other financial measures, would eliminate the controversy over whether defense contractors' profitability should be compared with that of other companies, thereby reducing concerns about whether firms are comparable.

Financial data specific to the segments of a company that perform defense work is

generally not publicly available. A financial reporting system requiring defense contractors to annually report segment-level financial data, contained in their income statements and balance sheets, could identify whether excessive profits were being made on defense contracts. This reporting system could alert policymakers that adjustments are needed in government policies to ensure profits earned on government contracts are fair and reasonable. This process could reduce the amount of audit and oversight by DOD on a contract-by-contract or cost-by-cost basis.

Conclusions and Action Needed

Contract overpricing amounting to billions of dollars continues to plague DOD's procurement system despite the existence of laws and regulations designed to prevent such overpricing. While DOD has taken steps to address some overpricing problems, other serious problems remain. Specifically, (1) contractors' cost-estimating systems are too often inadequate, (2) government oversight is too little and too late, and (3) the application of "penalties" is insufficient to change contractors' behavior in any meaningful way.

Unless more aggressive steps are taken, overpriced contracts will continue to plague the Department of Defense. Some of the steps that need to be taken are basic.

First, when defense contractors do not provide accurate, complete, and current data to the government or when they do not have the internal control systems to support this requirement, the government should use the full range of legislative and regulatory tools available to it to achieve compliance. If contractors continually overcharge the government or in some other substantive way fail to comply with government laws and regulations, progress payments should

be reduced or suspended, or the contractor should not be awarded future contracts.

Second, contracting officers and others involved in the contracting process have a responsibility to protect the government's interests. They should be provided the resources to do their jobs well, and they should be held fully accountable for the results. A significant step would be to change the procurement regulations to require prime contractors to report all subcontracts subject to audit under the Truth in Negotiations Act. Also, as DCAA's work load is reduced as a result of fewer contract actions, the Secretary of Defense should consider redirecting DCAA resources to other areas of contract risk that are now being inadequately covered.

Third, contractors should be allowed to make fair and reasonable profits, but they should not receive excessive profits from government contracts. To monitor contractor profits on defense contracts, the Congress should enact legislation requiring the government's contractors to annually report financial data specific to the segment doing defense work in each company. If effectively employed, the monitoring of contractors' return on capital and the

Conclusions and Action Needed

efficiency of their operations could be used as an alternative to reduce the amount of DOD audit and oversight on a contract-by-contract or cost-by-cost basis.

Related GAO Products

Contract Pricing: A Low Percentage of Contractors Are Responsible for Most Reported Defective Pricing (GAO/NSIAD-93-1, Nov. 24, 1992).

Contract Pricing: DCAA's Methodology Change in Identifying "High Risk" Contractors (GAO/NSIAD-92-183, June 2, 1992).

Contract Pricing: DCAA's Audit Coverage Lowered by Lack of Subcontract Information (GAO/NSIAD-92-173, May 29, 1992).

Contract Pricing: Estimating Deficiencies Resolved Slowly, but Recent DOD Actions Should Help (GAO/NSIAD-92-187, May 28, 1992).

Contract Pricing: DOD's Audit Follow-up System Is Inaccurate and Incomplete (GAO/NSIAD-92-138, May 28, 1992).

Contract Pricing: Subcontracts Are Significant in Prime Contract Defective Pricing (GAO/NSIAD-92-131, May 28, 1992).

Contract Pricing: Status of Defective Pricing (GAO/NSIAD-92-184FS, May 21, 1992).

Contract Pricing: Issues Related to the Defense Contract Audit Agency (GAO/NSIAD-92-188, May 6, 1992).

Contract Pricing: Threshold for Analysis of Subcontract Proposals Not Clear
(GAO/NSIAD-92-69, Mar. 20, 1992).

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

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(GAO/NSIAD-91-163, Aug. 16, 1991).

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Government Contracting: A Proposal for a Program to Study the Profitability of Government Contractors (GAO/NSIAD-87-175, Sept. 17, 1987).

Government Contracting: Assessment of the Study of Defense Contractor Profitability
(GAO/NSIAD-87-50, Dec. 23, 1986).

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