

March 21, 2003



Infrastructure and Environment

Public/Private Competition for the
Defense Finance and Accounting
Service Military Retired and
Annuitant Pay Functions
(D-2003-056)

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Acronyms

ACS	Affiliated Computer Services
AFGE	American Federation of Government Employees
CGA	Continuing Government Activity
DFAS	Defense Finance and Accounting Service
EPA	Economic Price Adjustment
FAR	Federal Acquisition Regulation
GAO	General Accounting Office
GS	General Schedule
GSA	General Services Administration
IG DoD	Inspector General of the Department of Defense
MEO	Most Efficient Organization
OMB	Office of Management and Budget



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

MAR 21 2003

The Honorable Dennis J. Kucinich
House of Representatives
Washington, D.C. 20515-3510

Dear Congressman Kucinich:

Pursuant to the letter of December 7, 2001, from your staff and your subsequent letter of January 22, 2002, as well as subsequent written and verbal inquiries to the former Deputy Inspector General, this Office conducted an audit entitled "Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions." The accompanying audit report (Report No. D-2003-056) documents a \$31.8 million error by a Defense Finance and Accounting Service (DFAS) consultant in the public/private competition that resulted in the award of an A-76 contract with a potential 10 year value of \$346 million to the contractor rather than to the lower in-house bid.

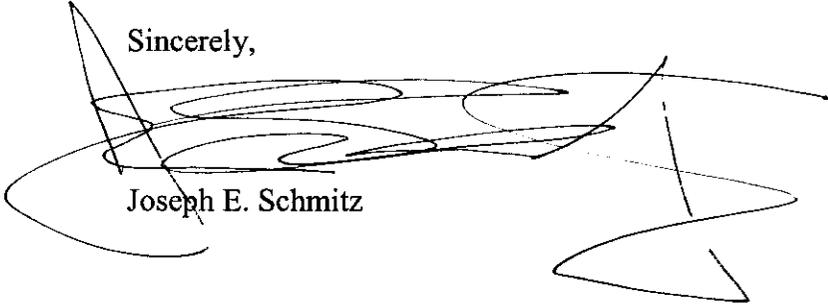
As a result of the failure of my audit personnel to identify this \$31.8 million error during pre-contract independent reviews, and because this Office utilized some of these same audit personnel from the previously flawed audit activities in conducting this most recent audit, the accompanying report contains the following disclaimer: "Knowledgeable third parties may consider the independence of these auditors to be impaired."

At the suggestion of your office and based upon my own review of these public/private competition audit activities (which commenced before the Senate confirmed me in March 2002), I have queried DFAS regarding "What options has DFAS considered, or will DFAS consider, in lieu of a recompetition, to address the concerns of the Most Efficient Organization (MEO) and former MEO personnel who may have been adversely affected as a result of errors that occurred in the competition for the Military Retired and Annuitant Pay Function, and therefore may feel entitled to be 'made whole'?"

Due to the errors identified in the accompanying report, I hereby retract two prior reports entitled "Independent Review of the Cost Comparison Study of Military Retirees and Annuitant Pay Functions" (D-2001-167) and "Independent Review of the Administrative Appeal Authority Adjustments for Transition Costs to the Military Retired and Annuitant Pay Functions Cost Comparison Study" (D-2002-023). Furthermore, before I took office last year, my staff had commissioned an independent internal review of the failures of my office; subsequently, I commissioned an independent external review by the General Services Administration Inspector General. The results of both the internal and the external independent reviews were concurring opinions that the work performed by my auditors relative to Audit D-2001-167 did not meet several generally accepted government auditing standards.

Finally, in order to avoid the need for adding "independence disclaimers" in future reports published by my office, I have issued a policy memorandum dated March 20, 2003, implementing independence standards within this Office of Inspector General and stating that "OIG personnel will not audit, inspect, or investigate their own work."

Sincerely,


Joseph E. Schmitz



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

March 21, 2003

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF DEFENSE
(INSTALLATIONS AND ENVIRONMENT)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Report on the Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions (Report No. D-2003-056)

We are providing this report for review and comment. We performed the audit in response to a congressional request. We considered management comments on a draft of this report in preparing the final report.

Due to the error that this report identified, Inspector General of the Department of Defense Report No. D-2001-167, "Independent Review of the Cost Comparison Study of Military Retired and Annuitant Pay Functions," August 2, 2001, and Report No. D-2002-023, "Independent Review of the Administrative Appeal Authority Adjustments for Transition Costs to the Military Retired and Annuitant Pay Functions Cost Comparison Study," December 11, 2001, are retracted.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, we revised Recommendation A.1.a. to clarify our intention. The Deputy Under Secretary of Defense (Installations and Environment) comments were not responsive for Recommendations B.1. and B.2., and the Director, Defense Finance and Accounting Service comments were not responsive to Recommendation A.1.a. and A.1.c. Therefore, we request that the Deputy Under Secretary of Defense (Installations and Environment) and the Director, Defense Finance and Accounting Service provide additional comments on those recommendations by April 21, 2003.

If possible, please provide management comments in electronic format (Adobe Acrobat file only). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature.

Questions should be directed to Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324) or Ms. Anella J. Oliva at (703) 604-9323 (DSN 664-9323). See Appendix D for the report distribution. The team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General of the Department of Defense

Report No. D-2003-056
(Project No. D2002CH-0074)

March 21, 2003

Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions

Executive Summary

Who Should Read This Report and Why? Defense officials responsible for Office of Management and Budget (OMB) Circular No. A-76 (Revised) cost comparisons should read this report because it addresses an economic price adjustment error in the in-house cost estimate, the need for appropriate guidance relating to Government overhead costs, and the need for accurate contract performance requirements.

Background. In December 1997, the Defense Finance and Accounting Service (DFAS) announced the decision to perform a public/private competition of its military retired and annuitant pay functions and compare the cost of Government versus private sector performance. About 650 positions at DFAS Cleveland and DFAS Denver were included in the cost comparison process. The 2 centers processed payments totaling about \$2.6 billion per month for 2.5 million military retirees and annuitants. On June 15, 2001, DFAS announced a tentative decision to award the contract to Affiliated Computer Services, Government Services Inc. and after the appeal process, on September 5, 2001, the contract was awarded to that contractor. The performance period of the contract was a 4-month transition-in period, ten 1-year options, and a 6-month transition-out period.

On August 14, 2001, Representative Dennis J. Kucinich and three members of Congress from Ohio sent letters urging DFAS not to finalize the contract for the military retired and annuitant pay functions. The letters identified perceived flaws that may have marred the cost comparison process. On September 7, 2001, the Director, DFAS disagreed with the assertions of error or impropriety that were in the congressional request and believed it was his obligation to move forward. On November 14, 2001, the Deputy Inspector General stated that a fact-finding review did not indicate that OMB Circular A-76 was circumvented; however, provisions concerning performance periods for cost comparisons were ambiguous and subject to interpretation. On November 15, 2001, the Deputy Inspector General sent a memorandum to the Under Secretary of Defense for Acquisition, Technology, and Logistics recommending additional guidance relating to whether extending the performance period beyond 5 years created a known cost advantage for the competing contractor. On December 7, 2001, Representative Kucinich's staff requested three additional issues be reviewed. See Appendix B for a discussion of the specific issues and the results of this review. Additional issues were identified that were outside the scope of the congressional request. These issues are addressed in the findings of the report.

Results. Although the competition process was completed and the contract was awarded, a calculation error of \$31.8 million over the performance period was identified for the in-house cost estimate; overhead costs of \$33.7 million for the same period, based on the OMB-directed 12-percent cost factor, were not reduced; and the contract had inadequate standards to measure performance.

The consultant that prepared the military retired and annuitant pay functions in-house cost estimate incorrectly calculated the personnel costs. In-house personnel costs for 426 of the 503 positions were incorrectly adjusted for inflation for the entire performance period instead of only the first year. The most efficient organization development team, DFAS management, and the Inspector General of the Department of Defense (the independent review officer) did not detect the error and the competition was awarded to the contractor based on a savings of \$1.9 million. However, had the error been identified prior to award, the Government's in-house cost estimate would have been reduced by \$31.8 million. DFAS should determine a specific course of action for the current contract, to include a determination of why a re-competition should not be held; and review and initiate appropriate action relating to the contractor, the most efficient organization development team, and associated management controls. Specific guidance from the Deputy Under Secretary of Defense (Installations and Environment) would increase the likelihood that the DoD A-76 community would properly determine whether economic price adjustments apply to personnel positions. See finding A for details of the results and recommendations.

The DFAS in-house cost estimate included \$33.7 million of "operations and general and administrative" overhead costs that were not reduced or otherwise affected by the conversion from in-house to contract performance. DFAS followed the procedures in the OMB Circular A-76 Revised Supplemental Handbook and was required to use the standard 12-percent cost factor for overhead costs because DoD did not develop and submit to OMB for approval an accurate overhead factor for DoD. However, after award of the contract, the overhead costs were not reduced or otherwise affected and continued to be a DFAS cost. Using the mandatory overhead factor affected the results of the cost comparison and reducing the overhead costs would have lowered the Government's in-house cost estimate. A supportable overhead rate for DoD operations and general and administrative overhead would result in fairer cost comparisons. See finding B for details of the results and recommendations.

The DFAS contract had inadequate standards in the performance requirements summary for 7 of 10 contract performance requirements. As a result, contractor performance cannot be fully or effectively evaluated and holding the contractor accountable for inadequate performance is difficult. Rewriting the performance requirements summary to include all contractor responsibilities defined in the performance work statement and reassessing the critical elements of contract performance would permit contractor performance to be fully and effectively evaluated. See finding C for details of the results and recommendations.

Management Comments and Audit Response. The Director, Defense Finance and Accounting Service generally concurred with the audit findings and recommendations. However, comments were only partially responsive because the Director did not provide specific information on the option selected and future course of action for the military retired and annuitant pay functions contract or when an independent review of the performance of the most efficient organization development team would occur. The Director, Competitive Sourcing and Privatization, Office of the Deputy Under Secretary of Defense (Installations and Environment) concurred with providing guidance on the proper use of economic price adjustments and disagreed with initiating any action to revise the 12-percent factor for overhead. We do not agree that the standard factor for overhead costs is a fair estimate for calculating overhead. We believe that DoD must develop a supportable rate or alternative methodologies that permit activities to compute reasonable overhead cost estimates. Accordingly, we request the Director, Defense Finance and Accounting Service and the Director, Competitive Sourcing and Privatization provide additional comments on the final report by April 21, 2003. See the Findings section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

Public/Private Competition for the Military Retired and Annuitant Pay Functions. In December 1997, the Defense Finance and Accounting Service (DFAS) announced the decision to perform a cost comparison of the military retired and annuitant pay functions. The cost comparison is a public/private competition process required by the Office of Management and Budget (OMB) Circular No. A-76 to compare the cost of Government performance with contract performance. The cost comparison included about 650 positions at 2 DFAS locations, about 500 positions at DFAS Cleveland and about 150 positions at DFAS Denver. These 2 centers processed payments totaling about \$2.6 billion per month for 2.5 million military retirees and annuitants.

On April 15, 1999, DFAS issued a solicitation requesting private sector proposals for performance of the military retired and annuitant pay functions for a 5-year period. However, in August of the same year, DFAS cancelled the solicitation due to management concerns that the performance work statement was not performance-based and industry concerns on complexity. On September 11, 2000, DFAS issued another solicitation requesting proposals for performance of the military retired and annuitant pay functions for a 10-year period. One contractor, Affiliated Computer Services (ACS), Government Services Inc. submitted a proposal to the solicitation. The contracting officer determined that the contractor's proposal was acceptable and responsive to the requirements of the solicitation. The contracting officer then compared the total cost of contract performance with the total cost of in-house performance to determine a tentative cost comparison decision.

On June 15, 2001, DFAS announced the tentative decision to award the contract to ACS Government Services Inc. The period to file administrative appeals began on June 18, 2001, and ended on July 17, 2001. The American Federation of Government Employees (AFGE) Locals 2040 and 3283 filed an appeal. As a result, the Administrative Appeal Authority corrected the in-house cost estimate by reducing the operational personnel costs for transition by \$16 million. The cost comparison reflected a total adjusted cost of contract performance of \$364.7 million compared to a total cost of in-house performance of \$366.6 million, representing a difference of \$1.9 million in favor of contract performance. Therefore, the Administrative Appeal Authority issued its final decision on August 6, 2001, stating there was insufficient evidence to change the tentative decision. On September 5, 2001, DFAS awarded the contract to ACS Government Services Inc. (the contractor). The performance period of the contract was a 4-month transition-in period, ten 1-year options, and a 6-month transition-out period. The transition-in period began on September 28, 2001, was completed on January 27, 2002, and the contractor began the first option year on January 28, 2002.

Congressional Inquiries. We performed the audit in response to inquiries made by Representative Dennis J. Kucinich concerning the decision to award the DFAS military retired and annuitant pay functions to a private contractor. On August 14, 2001, Representative Kucinich and three members of Congress from Ohio sent letters to the Comptroller General, the Director of DFAS, and the Deputy

Inspector General of the Department of Defense. The letters urged DFAS to suspend any activity aimed at completing a contract for the military retired and annuitant pay functions and requested the Comptroller General and the Inspector General of the Department of Defense (IG DoD) to investigate the cost comparison and appeal processes. The letters identified perceived flaws that may have marred the cost comparison process. The issues raised included the appointment of an administrative appeal authority, the extension of the performance period from 5 to 10 years, the costing of the Directorate of Continuing Government Activity, and the ability of the contractor to retain in-house technical support staff.

On August 21, 2001, the Deputy Inspector General agreed to examine the issues raised. On September 7, 2001, the Director, DFAS disagreed with the assertions of error or impropriety that were in the congressional request and believed it was his obligation to move forward. On November 14, 2001, the Deputy Inspector General stated that a fact-finding review of each issue did not indicate that OMB Circular A-76 was circumvented; however, provisions concerning performance periods for cost comparisons were ambiguous and subject to interpretation. On November 15, 2001, the Deputy Inspector General sent a memorandum to the Under Secretary of Defense for Acquisition, Technology, and Logistics recommending additional guidance on the issue of whether extending the performance period beyond 5 years creates a known cost advantage for the competing contractor.

On December 7, 2001, after a meeting with staff from the IG DoD, staff from Representative Kucinich's office sent a letter and requested three additional issues be reviewed.

- The Government's in-house cost estimate saved \$15 million over the contractor's cost proposal during the first 5 years of performance.
- An economic price adjustment clause was included in the contract.
- DFAS had over \$70 million in unfinanced requirements for the military retired and annuitant pay functions.

On January 17, 2002, we announced our audit. See Appendix B for a discussion of the specific issues and the results of the review. During the course of the audit, additional issues were identified that were outside the scope of the original request. These issues are addressed in the findings of the report.

OMB Circular A-76 Guidance. OMB Circular No. A-76, "Performance of Commercial Activities," August 4, 1983 (Revised), and OMB Circular A-76 Revised Supplemental Handbook, March 1996 (Revised), establish Federal policy regarding the performance of recurring commercial activities. The guidance sets forth the principles and procedures for implementing OMB Circular A-76, including the instructions for calculating the financial advantage to the Government of acquiring a service through in-house, contract, or inter-service support agreement resources.

DoD Guidance. DoD Directive 4100.15, “Commercial Activities Program,” March 10, 1989, and DoD Instruction 4100.33, “Commercial Activities Program Procedures,” September 9, 1985, update DoD policies, procedures, and assign responsibilities for commercial activities as required by OMB Circular A-76. On April 3, 2000, the Under Secretary of Defense for Acquisition and Technology issued interim guidance to ensure DoD agencies used a consistent approach when performing cost comparisons. The Competitive Sourcing and Privatization Office within the Office of the Deputy Under Secretary of Defense (Installations and Environment) Web site provides an overview of the cost comparison process. Agencies are required to:

- develop and issue a solicitation in accordance with the Federal Acquisition Regulation (FAR) to solicit offers from the private sector;
- develop and submit a certified, independently reviewed in-house offer;
- select a single private sector offer using one of the source selection processes required by the FAR;
- compare the in-house offer with the private sector offer to determine a tentative cost comparison decision;
- perform the Administrative Appeal Process to determine a final cost comparison decision; and
- implement and manage the final decision.

The November 1997 Defense Reform Initiative Report shows that public/private competitions for the performance of commercial activities result in costs avoided, usually through a reduction in personnel, whether the Government or the private sector wins the competitions.

Independent Review. OMB Circular A-76 Revised Supplemental Handbook and DoD Instruction 4100.33 require that all cost comparisons be reviewed and certified in writing by an impartial independent review officer organizationally independent of the commercial activity being studied and the activity preparing the cost comparison. The independent review is a required management control procedure for ensuring the credibility of the most efficient organization (MEO); the reliability and accuracy of the amounts presented on the cost comparison form; and the credibility, impartiality, and fairness of the OMB Circular A-76 process.

The independent review officer must certify that the data contained in the management plan and in-house cost estimate reasonably establish the Government’s ability to perform the performance work statement with the resources provided by the MEO and that all costs were prepared in accordance with OMB Circular A-76 and its Supplement. On February 13, 1998, DFAS requested that the IG DoD perform the independent reviews of five DFAS cost comparisons, including the military retired and annuitant pay functions cost comparison. IG DoD staff certified the in-house offer three times, on January 22, 2001, June 8, 2001, and August 6, 2001.

Objectives

The overall audit objectives were to review selected portions of the OMB Circular A-76 process and the decision to award the military retired and annuitant pay functions to a private contractor, and to assess related performance risks. See Appendix A for a discussion of the audit scope and the methodology.

A. Economic Price Adjustment Determination

The consultant that prepared the military retired and annuitant pay functions in-house cost estimate incorrectly calculated the personnel costs. In-house personnel costs for 426 of the 503 positions were incorrectly adjusted for inflation for the entire performance period instead of only the first year. The MEO development team, DFAS management, and the independent review officer (IG DoD) did not detect the error and the competition was awarded to the contractor based on a savings of \$1.9 million (\$366.6 million minus \$364.7 million). However, had the error been identified prior to award, the Government's in-house cost estimate would have been reduced by \$31.8 million.

Economic Price Adjustment Guidance

Contracts Subject to the Service Contract Act. The Service Contract Act was established under sections 351 through 358, title 41, United States Code, to ensure that Government contractors fairly compensate their service workers. FAR 22.1002-2, "Wage Determinations Based on Prevailing Rates," states:

Contractors performing on service contracts in excess of \$2,500 to which no predecessor contractor's collective bargaining agreement applies shall pay their employees at least the wages and fringe benefits found by the Department of Labor to prevail in the locality or, in the absence of a wage determination, the minimum wage set forth in the Fair Labor Standards Act.

Economic price adjustments (EPA) for labor wages and fringe benefits are included in the FAR. When a solicitation includes FAR 52.222-43, "Fair Labor Standards Act and Service Contract Act-Price Adjustment (Multiple Year and Option Contracts)," the contractor is required to warrant that the prices in the contract do not include any allowance for any contingency to cover increased costs for which adjustments are authorized. The clause requires contract price adjustments to reflect the contractor's actual increase (or decrease) to applicable labor wages and fringe benefits when Department of Labor wage determinations are incorporated into a contract. Therefore, the contract price is only adjusted for the difference between what the contractor is paying before the adjustment and the new wage determination.

OMB Circular A-76 Policy for In-House Wages and Salaries. In order to provide a level playing field between public and private offers, the in-house cost estimate is required to reflect similar EPA restrictions for Government labor wages and fringe benefits. Therefore, the in-house offer does not include inflation for personnel costs that are subject to an EPA beyond the end of the first performance period. Positions not subject to the EPA are adjusted for inflation consistent with the economic assumptions used in the President's most recent budget through the end of the performance periods.

OMB Circular A-76 Revised Supplemental Handbook, Part II, “Preparing the Cost Comparison Estimates,” chapter 2, paragraph B. 8. states:

All in-house wages, salaries and other costs are adjusted for inflation consistent with the economic assumptions used in the President’s most recent Budget, through the end of the first year of performance. Federal wages and salaries from contracts that contain an economic adjustment clause or are subject to the Service Contract Act (SCA) (41 USC 351-357) or the Davis-Bacon Act (DBA) (40 USC 276a-276a-7) are inflated to the end of the first performance period. However, when using the Department of Labor criteria, certain potential contract positions may not be covered under the SCA/DBA provisions; accordingly, the in-house related costs for such positions are escalated through the end of the cost comparison period.

Cost Comparison Costing Software. DoD required that in-house cost estimates be prepared using costing software developed specifically for OMB Circular A-76 cost comparisons. The DoD A-76 costing software requires each personnel position to be designated as either subject to an EPA or not subject to an EPA. When applicable, the EPA provision is marked “yes” for any MEO position that is equivalent to a labor category found on the Department of Labor Service Contract Act Directory of Occupations.

Development of the In-House Offer

Consultant Support. DFAS contracted with a consultant, MEVATEC Corporation, to provide technical and analytical support to the MEO development team from June 12, 2000, to June 30, 2001. MEVATEC had provided consulting support to DoD on numerous OMB Circular A-76 cost comparisons since 1995. The contract required MEVATEC to interface daily with the MEO development team, as well as coordinate requirements with the contracting officer. This was to ensure that MEVATEC made corrections and adjustments to the documents as they were reviewed. The contract included the following technical and analytical support.

- Develop a costing methodology, including an explanation of how the MEO costs would be generated, processed, presented, and validated.
- Provide technical and administrative support to present and defend the costing methodology and procedures.
- Develop a plan for conducting the management plan.
- Develop the management plan, which included the MEO, the in-house cost estimate, the transition plan, and the technical performance plan.

Specifically, the contract stated:

The contractor shall be responsible for all IHCE [in-house cost estimate] related research, compilation, analyses, and subsequent assembly of all required cost forms and supporting documentation.

Cost of Consultant Support. DFAS paid MEVATEC \$218,474 to provide support for the military retired and annuitant pay functions cost comparison. The MEVATEC consulting team consisted of a project manager, three senior analysts, one financial analyst, and one administrative employee.

Table 1 shows the hours worked and all associated costs for technical and analytical work.

<u>Labor Category</u>	<u>Hours Worked</u>
Contract Project Manager	843.0
Senior Cost Analyst	210.0
Senior Financial Analyst	587.0
Senior Financial Analyst II	640.0
Financial Analyst I	51.0
Administrative/Technical Support	<u>533.5</u>
Total Labor Hours	2,864.5
Total Labor Costs	\$217,064
Travel Costs	935
Other Direct Costs	<u>475</u>
Total Contract Price	\$218,474

Personnel Positions Subject to an EPA

DFAS Guidance on EPA Determination. The MEO that was developed consisted of 503 positions that required an EPA determination. The DFAS A-76 study manager provided the following guidance to MEVATEC on personnel positions subject to an EPA:

In accordance with the Code of Federal Regulations (29 CFR Part 541), professional employees (Accountants GS-510) are considered exempt and would not be subject to an EPA. Nonprofessional employees (Accounting Technicians GS-525, Accounts Maintenance Clerks GS-525 and Financial Assistants GS-303) are considered non-exempt and would be subject to an EPA.

Based on the above guidance, the personnel costs associated with 502 positions should have been adjusted for inflation through the first year of the performance period and the personnel cost for 1 position should have been adjusted for inflation through the entire performance period.

Consultant EPA Determination of Personnel Positions. MEVATEC made an error in the in-house cost estimate and reversed the EPA determination on all 503 positions. MEVATEC classified 502 positions in the in-house cost estimate as not subject to an EPA (coded “no” in the DoD A-76 costing software) and classified 1 position as subject to an EPA (coded “yes”), exactly opposite of what DFAS intended. Because of the EPA determination error, the personnel costs of the 502 positions were adjusted for inflation through the entire performance period instead of only the first year. Based on this EPA determination, the cost comparison form showed a decision in favor of the contractor by \$1.9 million. See Appendix C, Table C-1.

The MEO development team, DFAS management, and the IG DoD (the independent review officer) did not detect the error prior to DFAS submitting the in-house offer on January 22, 2001, or on subsequent revisions. The DFAS A-76 study manager revised the in-house offer twice after the initial submission, once because OMB required the in-house cost estimate to be updated to include the latest inflation factors and once to adjust for the administrative appeal authority decision. The IG DoD reviewed the in-house offer both times, and re-certified it on June 8, 2001, and August 6, 2001, which will be discussed later in more detail.

DFAS Intended EPA Determination of Personnel Positions. The in-house cost estimate was significantly reduced when the personnel positions were classified with the EPA determination that DFAS originally intended. Based on an EPA determination of 502 positions subject to an EPA (coded “yes” in the DoD A-76 costing software) and 1 position not subject to an EPA (coded “no”), the personnel costs associated with the 502 positions were adjusted for inflation for only the first year of the performance period. This EPA determination would have reduced the in-house cost estimate by \$42.7 million. Due to the significance of this error, DFAS should review its consulting contract with MEVATEC and initiate appropriate action.

Revised EPA Determination of Personnel Positions. We determined during this audit that classifying 502 positions as subject to an EPA was also not fully correct. Although the majority of the positions were nonprofessional, the 502 positions subject to an EPA did include some higher graded professional positions, such as financial system specialists (General Schedule (GS)-501, grades 11-14). We discussed the issue of EPA determination when the Service Contract Act is applicable with the Assistant Director, Competitive Sourcing and Privatization, Office of the Deputy Under Secretary of Defense (Installations and Environment), who acknowledged that the EPA determination could be confusing. The Assistant Director provided us an issue paper discussing the Service Contract Act and the Fair Labor Standards Act. The issue paper stated that an objective approach would be to designate personnel positions as subject to an EPA when the position descriptions indicated the employees were not exempt from the Fair Labor Standards Act because both the Service Contract Act and the Fair Labor Standards Act used the same definition to exempt positions. Due to the impact the EPA determination makes on the personnel costs in the in-house cost estimate, guidance clarifying and emphasizing its importance needs to be issued to the DoD A-76 community.

Using the approach identified in the issue paper, we reviewed all personnel positions in the in-house cost estimate. We determined that 426 positions were not exempt from the Fair Labor Standards Act and, therefore, would be subject to an EPA (coded “yes” in the DoD A-76 costing software). At the same time, 77 positions were exempt from the Fair Labor Standards Act, and, therefore, were not subject to an EPA (coded “no”). We discussed our analysis and revised EPA determinations with DFAS and reached agreement on the revised EPA determination of the 503 positions in the in-house cost estimate. Based on this revised EPA determination, the total cost of in-house performance was \$334.8 million and total adjusted contractor cost was \$364.7 million, a difference of \$29.9 million. See Appendix C, Table C-2.

For the revised cost comparison in Table C-2, Figure 1 shows that the cumulative annual cost difference between the in-house cost estimate and the contractor proposal (excluding the \$10 million conversion differential) favors the in-house cost estimate.* The figure in Appendix B shows the cumulative annual cost difference between the in-house cost estimate and the contractor proposal without the EPA corrections.

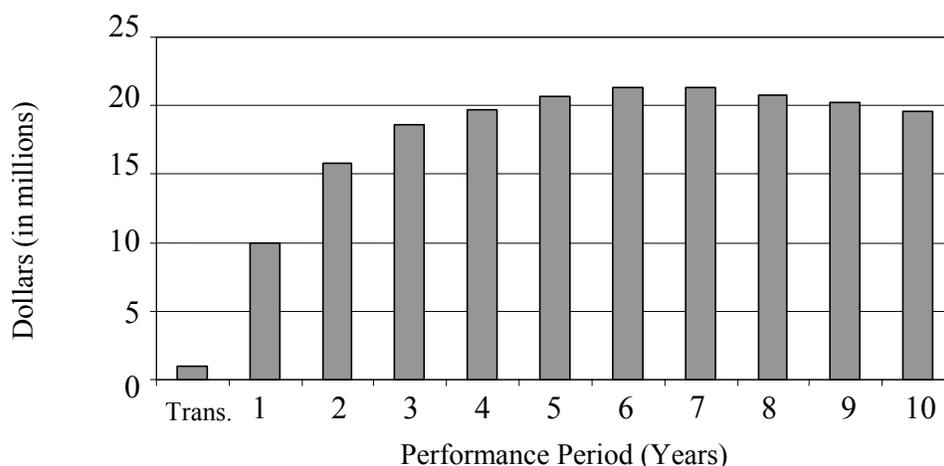


Figure 1. Cumulative Annual Cost Difference Between the In-House Cost Estimate With the Revised EPA Determination and the Contractor Proposal Favors the In-House Cost Estimate

* The \$10 million conversion differential was established to ensure that the Government did not undertake a conversion for marginal estimated savings. Factors such as decreased productivity and other costs of disruption that cannot be easily quantified at the time of the cost comparison are included in this differential.

Reviews and Certifications of In-House Cost Estimate

DFAS Management Reviews. The MEO development team worked in conjunction with MEVATEC to develop the management plan and in-house cost estimate, and should have reviewed the work to ensure its accuracy. OMB Circular A-76 requires a technically competent individual who is either organizationally independent of the function under competition or at least two levels above the most senior official included in the in-house cost estimate to certify the management plan as reflecting the Government's MEO. The Director, Pay System, Military and Civilian Pay Services certified on January 19, 2001, the in-house MEO for the military retired and annuitant pay functions cost comparison. The certification stated:

I certify that to the best of my knowledge and belief, the in-house organization reflected in this cost comparison is the most efficient and cost effective organization that is fully capable of performing the scope of work and tasks required by the Performance Work Statement. I further certify that I have obtained from the appropriate authority concurrence that the organization structure, as proposed can and will be fully implemented, subject to this cost comparison, in accordance with all applicable Federal regulations.

In addition, the cost comparison form shows the DFAS A-76 study manager prepared the in-house cost estimate. DFAS was required by OMB to develop the in-house cost estimate again to reflect changes to inflation factors in the President's budget. On June 8, 2001, the in-house offer was re-certified by DFAS. The final certification was signed on August 3, 2001, based on revisions made to the in-house cost estimate during the appeal process. The EPA determination error in the in-house cost estimate was not detected during any of these reviews and certifications. DFAS should review the performance of the MEO development team and associated management controls and initiate appropriate action. An office independent of the DFAS A-76 function should perform this review. In addition, DFAS should provide training to individuals involved in the cost comparison process on the proper determination of EPA to personnel positions.

Independent Review Officer. OMB Circular A-76 Revised Supplemental Handbook and DoD Instruction 4100.33 require that all cost comparisons be reviewed and certified in writing by an impartial independent review officer. The review is a required management control procedure for ensuring the credibility of the MEO; the reliability and accuracy of the amounts on the cost comparison form; and the credibility, impartiality, and fairness of the OMB Circular A-76 process.

From November 8, 2000, through January 22, 2001, the IG DoD conducted the independent review of the military retired and annuitant pay functions cost comparison. Prior to certifying the in-house offer on January 22, 2001, IG DoD staff identified three adjustments to the in-house cost estimate, which along with DFAS extending the transition period from 6 to 8 months, resulted in the in-house

cost estimate increasing by \$25.5 million. Specifically, IG DoD Report No. D-2001-167, "Independent Review of the Cost Comparison Study of Military Retired and Annuitant Pay Functions," August 2, 2001, identified the following adjustments to the in-house cost estimate that required DFAS correction prior to certification.

Location of DFAS Employees. The management plan indicated that 11 DFAS employees would remain at DFAS Denver during the initial period of performance, but the in-house cost estimate was based on an MEO entirely at DFAS Cleveland. Because the Denver area had a higher cost of living adjustment than Cleveland, the in-house cost estimate increased.

DFAS Automated Support Employees. The DFAS in-house cost estimate included the cost of 43 employees as additional costs (line 7 of the cost comparison form) that should have been included as personnel costs (line 1 of the cost comparison form). Because the line 7 costs did not include fringe benefit factors for the personnel involved or affect the overhead and insurance factors, moving the personnel to line 1 increased the in-house cost estimate.

Employee Salary Rates. DFAS did not use the 2001 GS salary rates effective January 7, 2001, to prepare the in-house cost estimate.

As the independent review officer, the Director, Contract Management Directorate, IG DoD, certified on January 22, 2001, and on June 8, 2001, that all costs were prepared in accordance with OMB Circular A-76 requirements.

I certify that I have reviewed the Performance Work Statement, Management Plan, In-House cost estimates and supporting documentation available prior to bid opening, and to the best of my knowledge and ability have determined that: (1) the ability of the in-house MEO to perform the work contained in the Performance Work Statement at the estimated costs included in this cost comparison is reasonably established, and (2) that all costs entered on the cost comparison have been prepared in accordance with the requirements of the Circular A-76 and its Supplement.

The EPA determination error in the in-house cost estimate was not detected during any of the IG DoD reviews and certifications. IG DoD Report No. D-2001-167 also incorrectly stated the individual costs associated with the three adjustments. Although the total increase of \$25.5 million to the in-house cost estimate was accurate, the individual costs associated with the three adjustments were not. In addition, the report incorrectly stated the costs associated with extending the transition period from 6 to 8 months. It is difficult to calculate the costs individually because the adjustments may affect each other, depending on the order in which they were made. Therefore, based on the EPA determination error and the individual adjustment cost errors, IG DoD Report No. D-2001-167 was retracted.

Administrative Appeal Authority. An administrative appeal is a challenge to a cost comparison decision based on asserted errors in the cost comparison process. To be considered an eligible appeal, the issues must be raised by eligible

appellants, meet criteria established in the OMB Circular A-76 Revised Supplemental Handbook, and be submitted in writing to the contracting officer prior to the end of the public review period.

On July 6, 2001, AFGE Locals 2040 and 3283 filed an appeal of the cost comparison decision. The appeal discussed 10 issues:

- attribution of transition costs to the MEO,
- extension of the period of performance,
- computation of the minimum cost differential figure,
- inclusion of inherently Government functions,
- training costs charged to the MEO,
- union involvement,
- validation of in-house estimates,
- presence of the union at bid opening,
- notification of award to the union and contractor, and
- a perceived conflict of interest.

The Administrative Appeal Authority reviewed the 10 issues and agreed with the appeal issue on the transition costs and decided that only incremental costs associated with the transition should be included rather than the full cost of operation during the transition period. The proposed cost reduction was not sufficient to change the outcome of the competition. Because the EPA determination error was not raised during the appeal process, it was not reviewed at that time. The IG DoD performed the independent review of the administrative appeal authority adjustments and certified the in-house cost estimate on August 6, 2001, after identifying three adjustments related to the MEO appeal that decreased the in-house cost estimate by \$18,881.

Actions Taken by IG DoD Management

Identification of the EPA Determination Error. On March 21, 2002, the audit team informed IG DoD management that the EPA determination error was not identified during the independent review process. On March 25, 2002, the Acting Assistant Inspector General for Auditing tasked the Deputy Assistant Inspector General for Audit Policy and Oversight to independently determine how the auditors that performed the independent reviews handled the issue of applying an EPA to personnel positions subject to the Service Contract Act. The Deputy Assistant Inspector General for Audit Policy and Oversight issued a memorandum and agreed that an EPA was incorrectly applied to personnel positions subject to

the Service Contract Act on the military retired and annuitant pay functions cost comparison. The memorandum also stated that although there was evidence of supervisory review, neither the auditor nor the supervisor recognized the incorrect coding of personnel positions subject to an EPA in the DoD A-76 costing software.

The Deputy Assistant Inspector General for Audit Policy and Oversight recommended that the audit steps in the IG DoD Audit Guide for Independent Review of OMB Circular A-76 Studies be revised to clearly show the reason the audit steps are being performed. In addition, the report recommended that an audit step be added to request documentation to show that each position was analyzed to determine if it was subject to an EPA. The Director, Contract Management Directorate, IG DoD, concurred with the recommendations and revised the audit guide accordingly.

Subsequently, on August 29, 2002, the Deputy Assistant Inspector General for Auditing requested that the Deputy Assistant Inspector General for Audit Policy and Oversight further review the performance of the independent review audit team. In a memorandum dated December 31, 2002, the Deputy Assistant Inspector General for Audit Policy and Oversight identified the need to address scope limitations and quality assurance processes especially oriented towards issuance of an independent review certification. On January 3, 2003, the Deputy Assistant Inspector General for Auditing directed that guidance be issued that addressed possible scope limitations and quality assurance processes. The guidance was implemented on February 7, 2003.

On December 13, 2002, the IG DoD requested the Inspector General for the General Services Administration (GSA) to independently review the issue. On February 20, 2003, the IG GSA issued a letter to the IG DoD that identified shortcomings in practice that substantially lessened the likelihood that the audit work would have detected the EPA determination errors made by agency management. The letter also stated that the IG DoD internal inquiries that identified the EPA error and the shortcomings in practice were thorough and credible.

Conclusion

DoD relies on OMB Circular A-76 public/private competitions to promote cost savings and increase the quality of service. An error was made in the DFAS military retired and annuitant pay functions cost comparison with respect to the determination of personnel positions subject to an EPA. Had this error been detected prior to the in-house offer submission, the in-house cost estimate would have decreased by \$31.8 million. The correct EPA determination may have changed the outcome of the cost comparison decision and retained the military retired and annuitant pay functions in-house. We believe it is the responsibility of DFAS to consider the results of this audit and to decide a future course of action on the military retired and annuitant pay functions contract, to include a determination of why a re-competition should not be held.

It appears that the accelerated process of the public/private competition and the reverse logic of EPA determination impacted this cost comparison. The DoD A-76 costing software requires each personnel position to be designated as either subject to an EPA or not subject to an EPA. When the EPA determination is “yes,” this means that “no” inflation is applied after the first performance period. When the EPA determination is “no,” this means that “yes” inflation is applied to all performance periods. This “yes-no” reverse logic creates unnecessary confusion and can lead to incorrect data entry. Because of this, the DoD A-76 costing software used for cost comparisons should be modified to include an explanation of how the positions will be adjusted for inflation when a “yes” or “no” is selected for EPA determination.

Management Comments on the Finding and Audit Response

Management Comments on Estimated Savings. The Director, DFAS concurred that the in-house cost estimate would have decreased by \$31.8 million if the correct EPA determination were used. However, he stated that the OMB Circular A-76 public/private competition process relies significantly on estimates and cost factors to compare the cost of public versus private performance of commercial activities, and that while the result of a cost comparison provides agencies with a basis upon which to make an award, the in-house cost estimate is not an absolute statement of the actual costs of performance. Therefore, he requested that the specific savings estimate be deleted from the report.

Audit Response. We stated that the correct EPA determination may have changed the outcome of the competition and reduced DoD costs over the performance period of the contract. While we agree with the Director, DFAS that the OMB Circular A-76 public/private competition process relies significantly on calculations and cost factors, we do not agree that savings cannot be calculated based on the cost comparison study. Figure 1 shows the annual cumulative cost difference between the contractor proposal and in-house costs estimate corrected for the EPA error. DFAS has the flexibility to not elect to exercise contract options and take alternative actions that will affect costs.

Recommendations, Management Comments, and Audit Response

Revised Recommendation. As a result of management comments, we revised Recommendation A.1.a. to clarify our intention that DFAS provide detailed information on a specific course of action for the retired military and annuitant pay functions contract.

A.1. We recommend that the Director, Defense Finance and Accounting Service:

a. Determine a specific course of action for the military retired and annuitant pay functions contract, to include a determination of why a re-competition should not be held.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated all available options would be evaluated to decide a future course of action that was cost effective and provide the best service possible for retired military and annuitant pay customers.

Audit Response. Although the Director concurred, he did not provide any specific information on the future course of action that was cost effective and would provide the best service possible for retired military and annuitant pay customers. Therefore, we ask that the Director provide additional comments in response to the final report specifically identifying the selected option and future course of action, to include a determination of why a re-competition should not be held.

b. Review contract MDA220-99-A-0025 and initiate appropriate action with the consultant that provided technical and analytical support on the military retired and annuitant pay functions cost comparison.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated that DFAS would review available legal options and determine appropriate actions. On March 5, 2003, DFAS stated they will assert the remedies that are afforded under the terms of the contract.

c. Review the performance of the most efficient organization development team for the military retired and annuitant pay functions cost comparison and associated management controls and initiate appropriate action. An office independent of the Defense Finance and Accounting Service A-76 function should perform this review.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated that the Under Secretary of Defense (Comptroller)/Chief Financial Officer directed a review on September 13, 2002. DFAS stated the review included all aspects of the retired and annuitant pay cost comparison and provided the report to the Under Secretary of Defense (Comptroller)/Chief Financial Officer on October 1, 2002. On February 27, 2003, DFAS provided a copy of the review and a list of all completed actions.

Audit Response. We consider the comments to be partially responsive. The review was not performed by an office independent of the A-76 function and did not include a review of the performance of the most efficient organization development team, as recommended. Therefore, we ask that the Director provide additional comments in response to the final report.

d. Provide training to A-76 study managers, contracting officers, and members of future management plan teams on the proper determination of the economic price adjustment to personnel positions in the in-house cost estimate.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated specific training will be provided to all affected participants on how to determine whether positions are subject to an economic price adjustment and the impact of the adjustment on computing personnel costs. In addition, the Director stated that DFAS has updated the Lessons Learned database and developed a Management Plan Certification Checklist and a DFAS Pre-Independent Review requirement to ensure the economic price adjustment is properly applied.

A.2. We recommend that the Deputy Under Secretary of Defense (Installations and Environment):

a. Issue guidance to the DoD A-76 community clarifying how to properly determine whether economic price adjustments apply to personnel positions that are subject to the Service Contract Act and emphasize the importance of correctly applying the economic price adjustment in the in-house cost estimate.

Management Comments. The Director, Competitive Sourcing and Privatization, Office of the Deputy Under Secretary of Defense (Installations and Environment) concurred and stated that the policy for applying inflation must be improved. The Director suggested to OMB that they consider that economic price adjustments for Government employee positions be based on the applicability of the Fair Labor Standards Act and not the Service Contract Act, which is applicable only to the private sector. The Director stated the update to DoD A-76 related regulations would begin when OMB publishes the revised Circular.

b. Modify the DoD A-76 costing software used for cost comparisons to include an explanation of how the most efficient organization positions will be adjusted for inflation when “yes” or “no” is selected for the economic price adjustment determination.

Management Comments. The Director, Competitive Sourcing and Privatization concurred and stated that the DoD A-76 costing software currently has four separate features or check points for flagging or assisting with economic price adjustment designations. The Director stated that when the software is updated based on the requirements in the revised Circular, additional improvements would be investigated.

B. Policy on Overhead Costs

The DFAS in-house cost estimate included \$33.7 million of “operations and general and administrative” overhead costs that were not reduced or otherwise affected by the conversion from in-house to contract performance. DFAS followed the procedures in the OMB Circular A-76 Revised Supplemental Handbook and was required to use the standard 12 percent cost factor for overhead costs because DoD did not develop and submit to OMB for approval an accurate overhead factor for DoD. However, the overhead costs were not reduced or otherwise affected and continued to be a DFAS cost. Using the mandatory overhead factor affected the results of the cost comparison and reducing the overhead costs would have lowered the Government’s in-house cost estimate.

Overhead Guidance

OMB Circular No. A-76 Revised Supplemental Handbook, Part II, “Preparing the Cost Comparison Estimates,” provides cost comparison guidance to comply with the provisions of the Federal Activities Inventory Reform Act and OMB Circular A-76.

Chapter 2, “Developing the Cost of Government Performance,” section E, “Overhead, Line 4,” paragraphs 2. and 3. state:

2. Line 4 includes two major categories of cost. The first is operations overhead and is defined as those costs that are not 100 percent attributable to the activity under study, but are generally associated with the recurring management or support of the activity. The second is general and administrative overhead and includes salaries, equipment, space and other activities related to headquarters management, accounting, personnel, legal support, data processing management and similar common services performed outside the activity, but in support of the activity. **These costs are affected by the conversion of work to or from in-house, contract or ISSA [interservice support agreements]. [Emphasis added.]**

3. For each year of the cost comparison, Line 4 is calculated by multiplying Line 1, including fringe, by 12 percent (.12) and entering the total on Line 4. If military personnel are included in Line 1, apply the 12 percent factor to civilian MEO Line 1 costs only. The composite military rate should include all military related overhead.

Chapter 2, section A, “General,” paragraph 2., “Standard Cost Factors,” states:

Standard cost factors are to be used as prescribed in this Part. Agencies are encouraged to collect agency or sector-specific data to update and improve upon the standard cost factors provided herein. The official in

paragraph 9.a. of the Circular, or designee, may develop alternative agency-wide or sector-specific standard cost factors, including overhead, for approval by OMB.

The OMB Circular A-76, paragraph 9.a. official is responsible for implementation of the A-76 Circular and the Revised Supplemental Handbook and is generally at the assistant secretary or equivalent level within the agency. Within DoD, the official responsible for implementation of the OMB Circular A-76 is the Deputy Under Secretary of Defense (Installations and Environment).

Operations Overhead. The OMB Circular A-76 Revised Supplemental Handbook defines operations overhead as those costs that are not 100 percent attributable to the activity that is undergoing a cost comparison, but are generally associated with the recurring management or support of the activity. DoD Instruction 4100.33, “Commercial Activities Program,” September 9, 1985, (incorporating through change 3, October 6, 1995) provides guidance that states “overhead costs shall be computed only when such costs will not continue in the event of contract performance.” Specifically, it states:

To compute operations overhead cost for the supervisory work center one level above the function under study, determine if at least one position would be eliminated in the supervisory work center as a result of conversion to contract if not, operations overhead is zero.

General and Administrative Costs. The OMB Circular A-76 Revised Supplemental Handbook defines general and administrative overhead as including salaries, equipment, space, and other activities related to headquarters management, accounting, personnel, legal support, data processing management, and similar common services performed outside the activity, but in support of the activity. DoD Instruction 4100.33 states:

To compute G&A [general and administrative] costs, first list all activities internal to the installation that provide defineable support to the function under study, excluding operations overhead. Next, list those activities external to the installation which provide general or administrative support not available on the installation and which are essential to the operation of the function under study. Within each of these activities determine if there could be at least one position or overtime eliminated as a result of conversion to contract. If not, G&A overhead is zero. If positions could be eliminated, compute personnel costs per paragraph D, and other cost solely in support of those positions which would be eliminated.

DoD Interim Guidance on Costing. DoD issued interim guidance on calculating costs for the OMB Circular A-76 cost comparison process. DoD 4100.XX-M, “A-76 Costing Manual,” March 14, 2001, chapter 4, “Line 4, Overhead Costs,” paragraphs C4.1.1. and C4.1.2. state:

C4.1.1. This line represents 12% of Line 1, Civilian Personnel Costs, (including MEO subcontract QAEs [quality assurance evaluators] and contract administrators) to estimate overhead costs associated with

operations of the CA [commercial activity] being competed that (based on application of the policy specified in paragraph C1.1.2.) are not captured on Line 1 for the MEO.

C4.1.2. The standardized rate accommodates overhead costs that are not necessarily visible to the CA or installation, but are clearly included in and provided by the Department's budget and **represents costs that are comparable to those that a contractor must include, such as allocations for Chief Executive Officers, headquarters management support staff, etc. [Emphasis added.]** This factor includes costs that are not 100% attributable to the CA being competed but are generally associated with the recurring management or support of the CA. Use of the rate avoids a requirement to develop detailed allocations of all management and support costs within DoD and as provided by the Government at large to the commercial activity being competed.

DFAS General and Administrative Costs

DFAS general and administrative costs were not affected by the conversion of work from in-house to contract performance for the military retired and annuitant pay functions. The DoD A-76 costing software used for cost comparisons automatically multiplied Line 1 personnel costs by 12 percent to include \$33.7 million on Line 4, overhead costs, in the in-house cost estimate, as required by OMB Circular A-76 (Appendix C, Table C-1). We reviewed DFAS general and administrative cost data for the Financial Operations Working Capital Fund for FYs 1998, 1999, 2000, 2001, and for the months of October 2001 through March 2002. Specifically, we reviewed DFAS general and administrative overhead expense categories and found no relationship or any instances where general and administrative costs would be reduced by the conversion of work from in-house to contract performance.

Table 2 shows the cost categories for DFAS general and administrative expenses and the total DFAS direct costs for FY 2001. For DFAS to recover general and administrative expenses of \$280.1 million, it would have to apply a 22.1 percent cost recovery rate to its direct costs of \$1,267 million.

Table 2. DFAS General and Administrative Expense Costs for FY 2001

<u>Category</u>	<u>Dollars</u> <u>(millions)</u>	<u>Percent</u>	
		<u>Expenses</u>	<u>Direct Costs</u>
Labor and Benefits	\$128.1	45.7	10.1
Other Services	79.5	28.4	6.3
Rents, Communications, Utilities	26.3	9.4	2.1
Other Costs-Depreciation	23.2	8.3	1.8
Equipment	8.8	3.1	0.7
Supplies and Materials	6.2	2.2	0.5
Travel	5.6	2.0	0.4
Printing and Reproduction	1.3	0.5	0.1
Transportation	0.9	0.3	0.1
Interest and Dividends	0.2	0.1	0.0
Total General and Administrative Expenses	\$280.1	100.0	22.1
Total Direct Costs	\$1,267.0		

Labor and Benefits. The labor and benefits category represents the highest percentage of DFAS general and administrative costs, at 45.7 percent. As of October 2001, the DFAS headquarters organization consisted of 351 personnel in 16 offices.

We reviewed 5 DFAS offices and interviewed DFAS staff in 4 of the offices, representing 226 personnel, or 64 percent of the total headquarters organization. DFAS staff could not identify any functions, personnel, or other costs that would be eliminated or reduced due to the award of the contract for the military retired and annuitant pay functions.

Table 3 shows the offices reviewed and number of personnel assigned.

Table 3. Offices Reviewed Within the DFAS Headquarters Organization

<u>Office</u>	<u>Personnel</u>	<u>Percent of Headquarters</u>
Accounting	66	18.8
Finance	66	18.8
Systems Integration *	42	11.9
Human Resources	27	7.7
Information and Technology	25	7.1
Subtotal	226	64.3
Total Headquarters Organization	351	

* Declined to be interviewed; stated they were not affected.

Other Services. The other services category represents 28.4 percent of the general and administrative costs. This category includes contract studies and

analyses, and professional and managerial services provided by contractors. These services would still be incurred by DFAS regardless of contracting the military retired and annuitant pay functions.

Rents, Communications, Utilities. The rents, communications, and utilities category is the third highest percentage of DFAS general and administrative expenses at 9.4 percent. We found no instance where these costs would be reduced. In addition, although in-house costs relating to rent, communications, and utilities for the military retired and annuitant pay functions were included in the DFAS general and administrative costs, these costs were considered common costs for the cost comparison process. Consequently, as provided by DoD Instruction 4100.33, these common costs would be provided to both the contractor and in-house team and are considered equal for both teams.

Other Costs-Depreciation. The other costs-depreciation category represents 8.3 percent of DFAS general and administrative expenses. Depreciation is measuring the decrease in value of an asset. Again, these costs were not affected at the DFAS headquarters level by contracting out the military retired and annuitant pay functions and were the same for the in-house and contractor teams because DFAS provides the facilities to the contractor.

General Accounting Office

The General Accounting Office (GAO) addressed the basis for the OMB requirement that a standard 12 percent overhead rate be applied to in-house cost estimates, regardless of the type of commercial activity or where in the country the activity is to be performed. GAO Report No. GAO/NSIAD-98-62, "Defense Outsourcing: Better Data Needed to Support Overhead Rates for A-76 Studies," February 1998, stated that OMB required that Government agencies include overhead costs in their in-house cost estimates prior to the adoption of a standard rate in March 1996. However, GAO stated that overhead costs, particularly general and administrative costs, were not included in some of the Government estimates because they were difficult to quantify and allocate to specific activities. When agencies did include overhead costs, they generally ranged from 1 to 3 percent of the direct labor costs. The report also stated:

Because actual cost data in Government agencies have historically been unavailable and unreliable, OMB told us it lacked meaningful information on which to develop a standard overhead rate or to differentiate between particular types of activities or regions of the country. Absent this data, OMB selected a single overhead rate of 12 percent, a rate that was near the midpoint of overhead rates suggested by Government agencies and private sector groups. ... While the 12 percent rate represents an appropriate move toward including overhead costs in government cost estimates, until actual overhead costs are captured, the magnitude of savings expected will be uncertain and the results of A-76 studies are apt to continue to be controversial.

Policy on Overhead Costs

OMB Circular A-76 guidance generally addresses operations overhead while the DoD Interim A-76 Costing Manual states that the standard rate for overhead includes costs comparable to those that a contractor must include, such as allocations for Chief Executive Officers and headquarters management support staff. Technically, this means that in-house performance costs should include costs associated with the Director of DFAS. This rationale appears questionable because when a contractor wins a competition, these Government overhead costs may not be eliminated and, therefore, the Government may continue to pay them. However, when the in-house team wins the competition, the Government does not pay these overhead costs for the contractor. The Deputy Under Secretary of Defense (Installations and Environment) should perform a study to identify and quantify those overhead costs that are affected by the conversion from in-house to contractor performance and clarify its guidance to provide that unaffected overhead costs will not be included in operations and general and administrative overhead costs. For example, Table C-1 shows a cost comparison decision in favor of the contractor by \$1.9 million; however, the in-house costs include \$33.7 million of overhead costs that may not be affected by the conversion to contract.

OMB Circular A-76 guidance on general and administrative overhead costs is less vague, stating that these costs are affected by the conversion from in-house to contract. The Deputy Under Secretary of Defense (Installations and Environment) needs to either establish a reasonable and supportable rate for operations and general and administrative overhead and submit the rate to OMB for approval and use or preferably, obtain OMB approval of alternative methodologies that permit activities to determine appropriate overhead cost reductions that will be included in the Government's in-house cost estimate for use in future OMB Circular A-76 cost comparison studies instead of using the standard 12 percent cost factor.

Industry Make or Buy Decisions

We contacted a major Defense contractor and reviewed its policy for make or buy decisions to determine whether general and administrative overhead costs were applied to the costs of a "make" item. The contractor representative responsible for developing the make or buy process stated that general and administrative overhead costs of the organization were generally not included in the make costs because these costs remained basically the same regardless of the decision. However, if specific general and administrative costs that would be reduced or eliminated based on a buy decision were identified, these costs would be factored in the make or buy decision.

Conclusion

Two of the key premises of the OMB Circular A-76 cost comparison studies are fairness of the competitions and achieving realistic cost savings. These premises can only be realized when supportable cost data are used for the cost comparison decisions and when all costs associated with either in-house or contractor performance are eliminated depending on the winner of the competition. If in fact these operations and general and administrative overhead costs are not eliminated when a contractor wins a competition, there would be skepticism about the fairness of the competition and achieving realistic cost savings. In this OMB Circular A-76 public/private competition—even though DFAS fully complied with OMB and DoD guidance on the use of the overhead factor—the use of the 12 percent overhead factor affected the results of the cost comparison and DFAS managers were not empowered to make a sound and justifiable business decision.

Management Comments on the Finding and Audit Response

Management Comments on the Standard Overhead Factor. The Director, Competitive Sourcing and Privatization, Office of the Deputy Under Secretary of Defense (Installations and Environment) stated that he was comfortable with the compromise used by OMB to arrive at the 12 percent factor and believes it is a fair estimate that standardizes the approach for calculating overhead. He further stated that since 1996, when OMB issued the 12 percent overhead policy, no DoD Component has pursued the use of a different rate and that a study of such costs is as likely to result in a higher rate as in a lower rate.

Audit Response. In the competitive sourcing process, all significant in-house costs are researched, identified, and supported except for overhead. There is absolutely no data to support 12 percent as a realistic cost rate. As a result, multimillion-dollar decisions are based, in part, on a factor not supported by data.

Recommendations, Management Comments, and Audit Response

B. We recommend that the Deputy Under Secretary of Defense (Installations and Environment):

1. Perform a study to identify and quantify those overhead costs that are affected by the conversion from in-house to contractor performance and, in conjunction with the Office of Management and Budget, clarify guidance so that unaffected overhead costs will not be included in operations and general and administrative overhead costs.

Management Comments. The Director, Competitive Sourcing and Privatization nonconcurred stating that during development of the revised OMB Circular A-76,

he discussed with OMB the IG DoD concerns regarding the overhead factor and the guidance in the current Circular. The results of these discussions are reflected in the proposed revision to the Circular issued in the Federal Register on November 14, 2002. He further stated that in the near future, his emphasis and efforts will be focused on the development of DoD policies and procedures to implement the significant changes in the Circular.

Audit Response. We consider the Director, Competitive Sourcing and Privatization comments to be nonresponsive. The proposed revision to the Circular still includes the 12 percent factor that is unsupported. Therefore, we ask that he reconsider his position and provide additional comments in response to the final report.

2. Either develop a supportable rate for DoD operations and general and administrative overhead or develop alternative methodologies that permit activities to compute reasonable overhead cost estimates instead of using the standard 12 percent cost factor in Office of Management and Budget Circular A-76 cost comparison studies, and submit to the Office of Management and Budget for approval and use.

Management Comments. The Director, Competitive Sourcing and Privatization nonconcurred but stated he will consult with DFAS to determine if a study is feasible for an alternate approach to determine the overhead factor for purposes of public-private competition. However, he stated such a study would require working with OMB, an approach consistent with the overhead policies stated in the revised Circular, and the development of a single DoD overhead rate to be used by all DoD Components because based on his past experiences with non-standard rates or calculations, he would not support a non-standard DoD overhead rate or method to calculate overhead.

Audit Response. The Director, Competitive Sourcing and Privatization comments do not address a major cost issue that can affect numerous competitive sourcing decisions. We are unaware of any other contracting process that permits using a factor of 12 percent of personnel costs, as overhead is calculated, that is not supported by any data. Unless DoD develops a supportable rate or an alternative method to calculate a fair and reasonable rate, the results of future competition will be questionable. Therefore, we ask that he reconsider his position and provide additional comments in response to the final report.

C. Contract Performance Requirements

The DFAS contract for the military retired and annuitant pay functions had inadequate standards in the performance requirements summary for 7 of 10 contract performance requirements. This occurred because five performance requirements did not accurately correlate to the contractor responsibilities defined in the performance work statement. In addition, two of the key performance requirements relating to customer service were not measurable and were not identified as critical elements of the contract. DFAS evaluated contractor performance on the three adequate standards as well as one of the inadequate standards and the contractor was deficient on three of the four evaluated standards. As a result, contractor performance could not be fully or effectively evaluated and holding the contractor accountable for inadequate performance would be difficult.

Establishing Performance Requirements

The DFAS performance work statement team developed the performance requirements summary. The requirements within the summary were established to measure the essential work of the performance work statement that would need to be completed in order to effectively maintain the pay accounts for military retirees and their annuitants. DFAS stated the performance requirements and acceptable quality levels were derived and validated against the performance requirements that DFAS established in its performance contract with the Defense Management Council as expectations for performance by DFAS in FY 2000 through FY 2005. The solicitation identified 11 performance requirements to evaluate contractor performance. However, depending on whether the contractor chose to use Government-provided systems, contractor-provided systems, or a combination of both to do the work, not all performance requirements were applicable. Based on the contractor's choice to use the Government-provided systems, only 10 performance requirements in the performance requirements summary were applicable.

The DFAS Continuing Government Activity (CGA) was established to oversee the quality of work provided by the contractor and was responsible for conducting monthly evaluations. The monthly evaluations consisted of reviewing contract performance on the 10 applicable performance requirements. The CGA coordinates with the contracting officer and is the Government point of authority for any deviations, corrective actions, complaints, or other issues relating to the contractor.

Performance Standards

The DFAS contract for the military retired and annuitant pay functions had inadequate standards for 7 of 10 contract performance requirements. Five performance requirements did not accurately correlate to the contractor

responsibilities defined in the performance work statement and two performance requirements were not measurable and were not identified as critical elements of the contract.

Correlation of Contract Performance Requirements. Five of the contract performance requirements did not accurately correlate to the contractor responsibilities defined in the performance work statement and, therefore, were not properly evaluated.

Pay Retirees and Annuitants in a Timely Manner. The standard for this performance requirement states “retiree and annuitant pay (EFT [electronic fund transfer] and checks) released no later than two (2) days before payday,” which indicates that ACS Government Services Inc. is responsible for issuing the actual payments to the retirees and annuitants. However, the performance work statement accurately states that the Government will make the actual payments, but that the contractor is responsible for submitting the required information to the DFAS disbursing office so that the retirees and annuitants will be paid on time. We believe this performance requirement needs to be rewritten so that the contractor can be effectively evaluated.

Process Notifications. This performance requirement was not evaluated as a separate requirement, but was combined with the “maintain existing accounts and process changes” requirement, because the CGA concluded that these two requirements were evaluating the same required service of processing customer change requests. After reviewing the appropriate sections of the performance work statement, we determined that the “process notifications” requirement, which is written “respond to correspondence either within 30 days or before the next payroll update,” relates to Freedom of Information Act, congressional, and other requests that come in to DFAS regularly, not just customer change requests. The requirement covers any reports that have to be supplied to DFAS and the Military Departments on a regular basis. The requirement also states that customers must be notified when changes are made to their account. The “maintain existing accounts and process changes” repeats the requirement of notifying customers when accounts are established and when changes are made to their accounts but is also the performance requirement that covers all changes made to an account, which can be initiated by the customers, the order of the Service Secretary, and the legislature. We believe the “process notifications” performance requirement should be evaluated separately and not combined with the “maintain existing accounts and process changes” requirement.

Manage and Process Debt Collection Activities. This performance requirement states “all debt collections identified and corresponding actions accomplished within 30 calendar days of receipt of initial action.” The CGA concluded that this requirement was not relevant and did not evaluate contract performance. However, the performance work statement defines certain debt collection responsibilities for which the contractor is responsible, such as collection of any amounts arising from overpayments to retirees and annuitants. We believe ACS Government Services Inc. should be evaluated on the services it is required to provide in the performance work statement. We believe this performance requirement should be rewritten to fit the services for which the contractor is responsible.

Manage Pay Services Automated Information System. The performance requirements summary is written to cover the connectivity service that ACS Government Services Inc. is not responsible for because of the option it chose. Therefore, the Director, CGA stated the contract performance on this requirement was not evaluated. However, after reviewing the performance work statement, we determined that it covers several services, in addition to the connectivity service, such as system maintenance, security access, system administration, and recommending changes to the DFAS Web page when needed. We believe the performance requirement should be rewritten to fit the services for which the contractor is responsible.

Complete Government Directed Automated Information System Maintenance Changes. This requirement was not evaluated in February 2002 because the system was the responsibility of DFAS in the previous month. The CGA stated that this requirement should be reworked, because the maintenance of the system is performed under the firm-fixed price portion of the contract. According to the performance work statement, the changes to the system caused by legislation, policy, new or existing requirements, system performance issues, or enhancements are the actions that fall under this requirement of the contract, not the maintenance of the system. We believe the performance requirement should be rewritten to fit the services for which the contractor is responsible.

Measuring Customer Service Performance Requirements. The two customer service performance requirements (call center and resolve pay problems) were not measurable or identified as critical performance requirements in the contract.

Provide Customer Service (Call Center). This requirement was not evaluated against the established standard, which was 80 percent of customer calls responded to within 20 seconds, because the Director, CGA stated DFAS does not have a system in place that measures how quickly a call is answered. However, the CGA did evaluate contract performance based on whether the calls were answered or not, which will be described later in more detail.

Provide Customer Service (Resolve Pay Problems). This requirement states “pay problems resolved within 30 calendar days of notification,” and was not evaluated as written because the CGA stated there was not a system in place to review the requirement.

Critical Performance Requirements

Critical Determination. DFAS stated that critical requirements were defined as the requirements that must be met by the contractor in order for DFAS to accomplish its mission. Critical requirements were identified as the quality and customer responsiveness metrics contained in the performance contract between the Defense Management Council and DFAS. Under the business area of payroll operations in the performance contract, which includes paying retirees and their annuitants, four metrics were established. Three of these metrics were covered by the four critical requirements in the performance requirements summary. The

fourth metric, “resolve all pay problems within 30 calendar days of receipt of correcting data,” was covered by the two noncritical customer service requirements in the performance requirements summary.

The performance requirements summary identified the critical performance requirements and associated pay deductions from the contract price that would be applied for not meeting the acceptable quality levels. The critical performance requirements were:

- pay retirees and annuitants in a timely manner,
- provide accurate pay and entitlement information to retirees and annuitants,
- establish new accounts, and
- maintain existing accounts and process changes.

However, providing accurate and timely responses to customer inquiries should also be critical elements of the military retired and annuitant pay functions contract based on the fourth metric of the performance contract.

Statistical Sampling of the Call Center. For a 2-week period ending March 22, 2002, the IG DoD performed 150 random calls to the DFAS Military Retired Call Center. The objective was to determine the average wait time callers experienced before having their questions answered. An automated voice system initially answered the phone call and provided options for the caller. It took approximately 90 seconds for a caller to get to the option of speaking with a customer service representative. Once this option was selected the caller was either placed on hold or was informed that the call could not be answered in a timely manner. Out of 150 calls, a customer service representative answered 105 calls, or 70 percent. Based on the sample results, we estimate with 95 percent confidence that the proportion of the successful calls was between 62 percent and 78 percent during that 2-week period. However, the average wait time before a customer service representative answered the call was 8.1 minutes. Based on the sample waiting times, with 95 percent confidence, we estimate the average wait time before a customer service representative answered the call was between 5.8 minutes to 10.3 minutes during that 2-week period.

Performance Benchmarking. Performance benchmarking is a structured, analytical method of comparing the performance of two or more call centers in order to determine best practice goals and to ensure competitive functionality. Benchmarking a call center can provide industry standards on data such as average speed of answer, average talk time, average calls abandoned, and average time in queue. Purdue University has a Center for Customer-Driven Quality that performs benchmarking analysis of call centers. One of their reports states that the most important caller satisfaction driver is the ability of a call center to answer callers’ questions on the first call with no transfers and no call-backs.

Prior DFAS Performance. DFAS had a goal to answer 85 percent of all calls prior to contracting out the military retiree and annuitant pay functions. For the months of February, March, April, and May 2001, DFAS achieved 76.8 percent,

85.2 percent, 89 percent, and 93.2 percent respectively. Figures 2 and 3 show a comparison of performance between DFAS and the contractor. Figure 2 compares the number of abandoned calls in a 4-month period between DFAS in 2001 and the contractor in 2002.

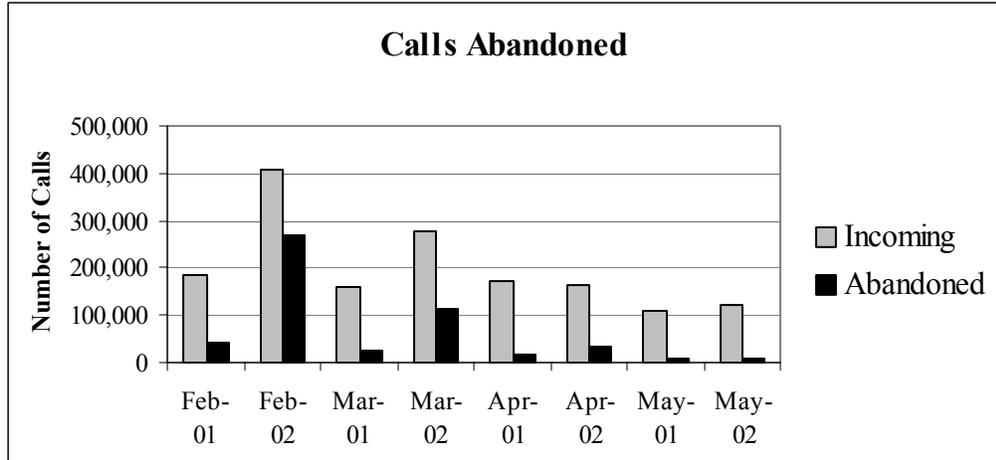


Figure 2. Number of Calls Abandoned by DFAS in 2001 and ACS Government Services Inc. in 2002

Figure 3 shows a comparison of the demand met by DFAS in 2001 and the contractor in 2002.

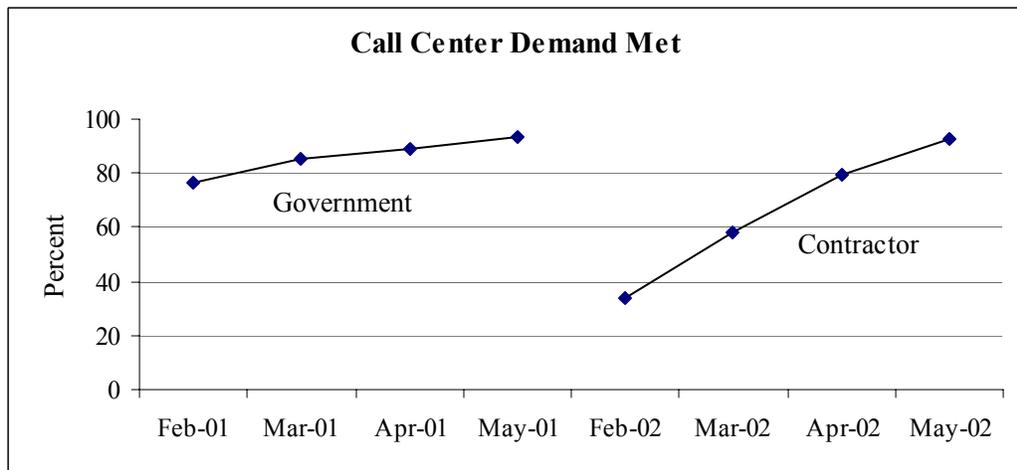


Figure 3. Comparison of Call Center Demand Met Between DFAS and the Contractor

The DFAS call center system currently in use by the contractor can determine how many calls were offered to the center and how many were answered. It can also determine the average wait time for a call to be answered. However, none of these elements were written in the performance requirements summary. We believe DFAS should perform a benchmarking analysis to determine areas of improvement by comparing contractor performance to industry standards.

Performance Standards Evaluation

DFAS evaluated contractor performance on the three adequate standards as well as one of the inadequate standards and the contractor was deficient on three of the four evaluated standards.

Maintain Existing Accounts and Process Changes. The CGA selected a random sample of all processed accounts for the month being evaluated. For each record in the random sample, the requested action filed by the retiree or annuitant was reviewed. The evaluator compared the request with the action the contractor performed to determine if the request was fully processed within 30 days. During February 2002, DFAS Cleveland and DFAS Denver interpreted the requirement differently, which resulted in inconsistent deficiencies. DFAS Cleveland evaluated for timeliness and accuracy, while DFAS Denver only evaluated for timeliness. The CGA identified the problem and corrected it, evaluating on both timeliness and accuracy in March and April. The acceptable quality level in FY 2002 was 99.2 percent. ACS Government Services Inc. achieved quality levels of 90.4 percent, 86.7 percent, and 88.2 percent for the months of February, March, and April, respectively. Therefore, the contracting officer issued deficiency reports for all 3 months. On July 2, 2002, the final review and comments sessions were completed for the February 2002 data and the contractor quality level was adjusted to 91.8 percent, which still did not meet the acceptable quality level of 99.2 percent.

Establish New Accounts. The CGA selected a random sample from all the accounts established in the given month. The sample was then reviewed to determine the number of accounts that were established in 30 days or less. The acceptable quality level for this requirement in FY 2002 was 98.2 percent. ACS Government Services Inc. achieved quality levels of 95.0 percent, 94.2 percent, and 97.2 percent for the months of February, March, and April 2002, respectively. Therefore, deficiency reports were issued for all 3 months. On July 2, 2002, the final review and comments sessions were completed for the February 2002 data and the quality level was adjusted to 97.2 percent, which still did not meet the acceptable quality level of 98.2 percent.

Provide Customer Service (Call Center). The established standard for this requirement is “80 percent of customer calls responded to within 20 seconds.” The Director, CGA stated that DFAS does not have the capability to measure the requirement based on the established standard. The CGA chose to measure the calls based on whether they were answered or not. The acceptable quality level set for this requirement was 80 percent for the life of the contract. ACS Government Services Inc. achieved quality levels of 33.6 percent, 58.3 percent, and 79.2 percent for the months of February, March, and April 2002, respectively. Therefore, deficiency reports were issued for all 3 months.

Provide Accurate Pay and Entitlement Information to Retirees and Annuitants. The contractor is responsible for maintaining the system that processes pay and benefits information. Errors found in February 2002 were not held against the contractor, because the CGA stated the system was the

responsibility of DFAS at the time of the error. The CGA stated that there were no errors found in March and April 2002. Therefore, deficiency reports were not issued on this requirement.

Conclusion

A properly written and executed performance requirements summary can provide a high degree of confidence in the assessment of contract performance. However, only 3 of 10 performance requirements for the military retired and annuitant pay functions contract could be evaluated against the established standards, and a fourth requirement was evaluated but not against the established standard. The reasons given why the remaining requirements were not measured were that the contractor was not responsible for the required service or that DFAS was not able to measure the requirement. In addition, the two performance requirements for customer services were not defined as a critical element of contractor performance, but clearly they meet the definition of critical, as defined by DFAS in its Performance Contract with the Defense Management Council. Thus, contractor performance on the military retired and annuitant pay functions contract cannot be adequately and effectively measured and holding the contractor accountable for inadequate performance would be difficult.

Recommendations and Management Comments

C. We recommend that the Director, Defense Finance and Accounting Service:

1. Rewrite the performance requirements summary to include all contractor responsibilities defined in the performance work statement, including a method to adequately measure the requirements.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated that DFAS would rewrite the performance requirements summary to include all mission critical services defined in the performance of work statement by March 31, 2003.

2. Conduct a benchmarking study on the two customer service requirements to identify the performance standards needed to be measured to ensure effective performance and change the standards for customer services to critical.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated DFAS will develop the requirements for a solicitation for a benchmarking study in the call management area by March 31, 2003. He stated DFAS would also clearly define what constitutes a pay problem and develop a methodology to measure performance against the standard by March 31, 2003.

3. Renegotiate the performance requirements summary in contract MDA220-01-C-002 based on the analysis in Recommendation C.1. and the study in Recommendation C.2.

Management Comments. The Director, Defense Finance and Accounting Service concurred and stated that renegotiation of the performance requirements summary will commence immediately after the results of the benchmarking study referenced in Recommendation C.2. are received and approved. He also stated that completion should occur within 60 days of commencement of negotiations.

Appendix A. Scope and Methodology

We reviewed the OMB Circular A-76 process on the DFAS military retired and annuitant pay functions cost comparison. We evaluated the performance work statement, MEO in-house cost estimate totaling \$366.6 million, and other supporting documentation to determine whether DFAS followed Federal and DoD guidance for cost comparison competitions. We discussed the competitive sourcing policies with the Office of the Deputy Under Secretary of Defense (Installations and Environment) and OMB officials. We reviewed total operation and general and administrative overhead costs of \$33.7 million. We reviewed DFAS general and administrative cost data for the Financial Operations Working Capital Fund for FYs 1998, 1999, 2000, 2001, and for October 2001 through March 2002. We interviewed the Directors or Deputy Directors of the Accounting, Finance, Human Resources, and Information and Technology divisions within the DFAS headquarters to determine if there was any reduction in workload due to the award of the contract. We reviewed headquarters personnel data as of October 2001. We reviewed the DFAS contracts with MEVATEC Corporation and ACS Government Services Inc. We reviewed contractor performance documents for February, March, and April 2002. We compared contract performance on call center demand met for February, March, April, and May 2002 with DFAS performance in February, March, April, and May 2001.

We did not review management controls over the DFAS public/private competition of the military retired and annuitant pay functions because the audit was conducted in response to a congressional request.

We performed this audit from December 2001 through November 2002 in accordance with generally accepted government auditing standards. Our review determined that the initial IG DoD independent review of the public/private competition of the military retired and annuitant pay functions did not identify a calculation error in the in-house cost estimate. We reported on the initial IG DoD independent review in IG DoD Report No. D-2001-167, "Independent Review of the Cost Comparison Study of Military Retired and Annuitant Pay Functions," August 2, 2001. We also reported on a review of the administrative appeal in Report No. D-2002-023, "Independent Review of the Administrative Appeal Authority Adjustments for Transition Costs to the Military Retired and Annuitant Pay Functions Cost Comparison Study," December 11, 2001. IG DoD Reports No. D-2001-167 and No. D-2002-023 were retracted. At the start of this review, we considered the prior independent review work and determined that the IG DoD personnel involved were independent and impartial to conduct this audit in accordance with Government Auditing Standards 3.11. However, the identification of the calculation error presented an unexpected independence issue. IG DoD personnel involved in the initial review and the review on the administrative appeal were also involved in this review. Knowledgeable third parties may consider the independence of these auditors to be impaired.

In relation to the statistical sample of the DFAS Military Retired Call Center (finding C); the target population was the telephone calls made by retirees and annuitants to the contractor-supplied telephone call center at DFAS. Available

statistics indicated that there were up to 40,000 calls per day coming into the call center. Given the high call volume, we did not expect the addition of 10-25 calls per day to be either obtrusive or to change the daily workload.

The main goals of our call center survey were to estimate how long a caller must wait to receive phone support and the percentage of the unsuccessful calls. Unsuccessful calls were defined as calls that were either disconnected or the waiting time was too long. In order to reduce the staff time in waiting, the observations were censored. That is, waiting time only up to 30 minutes was recorded. We made a random schedule of 150 calls during the 2-week time period of March 11, 2002, through March 22, 2002, to the DFAS retired and annuitant customer service center. We used a one-parameter exponential distribution to project the average waiting time and its confidence interval. A binomial model was used to project the proportion of the unsuccessful calls.

Use of Computer-Processed Data. We relied on computer-processed cost comparison data calculated by the DoD-approved COMPARE software program. This Air Force-developed program was released in November 1994 and was the software generally accepted for performing OMB Circular A-76 cost comparison studies by all the Military Departments and Federal agencies. On February 29, 2000, DoD interim guidance mandated use of COMPARE* for all DoD A-76 cost comparisons. Audits of the program by the Army Audit Agency concluded program cost comparison computations adequately documented costs in accordance with the OMB Circular A-76 Revised Supplemental Handbook guidance. Nothing came to our attention in this review that caused us to doubt the reliability of the computer-processed data.

Use of Technical Assistance. Personnel in the Quantitative Methods Division, Office of the Assistant Inspector General for Auditing of the Department of Defense developed the statistical sampling plan and selected the sample for this audit.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Infrastructure Management high-risk area and the Contract Management high-risk area.

Prior Coverage

During the last 5 years, the General Accounting Office and the Inspector General of the Department of Defense have issued numerous reports discussing the OMB Circular A-76 process, OMB Circular A-76 overhead rates, and public/private competitions. Unrestricted General Accounting Office reports can be accessed at <http://www.gao.gov>. Unrestricted Inspector General of the Department of Defense reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

* Subsequently, a contractor hired by the Air Force Manpower Innovation Agency, Randolph Air Force Base, Texas, developed win.COMPARE², a Windows-based personal computer application that replaced COMPARE in 2001.

Appendix B. Responses to Issues Raised by Congressional Inquiry

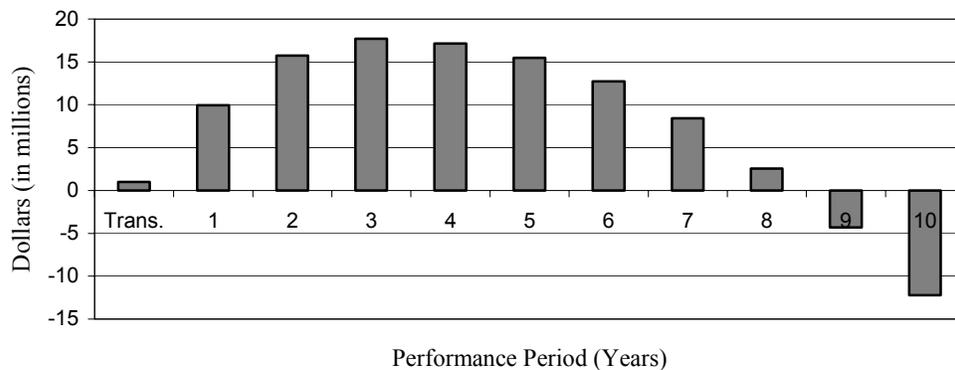
Issue 1. Cost Comparison Calculations

The December 7, 2001, letter from Representative Kucinich’s staff stated:

“[The AFGE local 3283 claimed in their appeal that] DFAS’ cost comparison calculations reveal \$15 million in savings over the contractor bid that the in-house team would provide during the first five years of the performance period. [This would require investigation] to determine whether the contracting officials at DFAS were explicitly or implicitly aware, prior to the ‘Certification of Approval of Performance Period in Excess of 5 Years’ that any savings the contractor would provide would be realized in years five through ten of the performance period.”

Audit Results. DFAS would not have had any knowledge of the contractor’s proposal or the Government’s in-house offer prior to approving the extension of the performance period from 5 to 10 years. In addition, OMB Circular A-76 policy does not allow for a year-by-year cost comparison of the selected private sector offer with the in-house offer; therefore, DFAS correctly compared the total costs of the entire performance period for this public/private competition. However, we do agree that a year-by-year cost comparison shows a \$15 million difference in favor of the Government over the first 5 years—in fact, the comparison shows that the Government does not realize any savings until year 9 of contract performance. However, once the in-house cost estimate was corrected for the economic price adjustment error (see finding A), the cost comparison shows a savings for the entire performance period in favor of the Government.

The following figure shows the cumulative annual cost difference between the in-house cost estimate and the contractor proposal for the cost comparison in Table C-1, excluding the \$10 million conversion differential.



Cumulative Annual Cost Difference Between the In-House Cost Estimate and the Contractor Proposal

Net Present Value. There is no requirement to consider net present value for OMB Circular A-76 cost comparisons. We believe consideration of net present value is particularly important for those competitions exceeding 3 years. The longer the period of performance, the greater the impact net present value will have on ensuring the best decisions are made for the benefit of the Government and the taxpayers. Application of the net present value concept (discount rate of 4.2 percent) to the public/private competition for the military retired and annuitant pay functions, shows the in-house cost estimate was \$5.3 million (\$297.3 million versus \$302.6 million) less than the contractor proposal, including the \$10 million conversion differential. We provided comments to OMB to consider net present value in the proposed revision to OMB Circular A-76.

Issue 2. Economic Price Adjustment Provision

The December 7, 2001, letter from Representative Kucinich's staff stated that adding an economic price adjustment (EPA) provision in the final contract would suggest fiscal irresponsibility on the part of DFAS.

Audit Results. FAR 16.203, "Fixed-Price Contracts with Economic Price Adjustment," states that a fixed-price contract with an EPA provides for adjusted revisions of the stated contract price upon the occurrence of specified contingencies. An EPA is used when it is necessary either to protect the contractor and the Government against significant fluctuations in labor or material costs or to provide for contract price adjustment in the event of changes in the contractor established prices. The EPA clause was not in the solicitation, but was in the ACS Government Services Inc. proposal and when DFAS accepted the proposal, they accepted the EPA clause. Due to the fact that this was a long-term contract, we did not question the decision to include the EPA clause.

Issue 3. Unfinanced Requirements

The December 7, 2001, letter from Representative Kucinich's staff also expressed concern about a possible \$70 million "unfinanced requirement" representing expenditures that DFAS would be required to make in order to contract out the military retired and annuitant pay functions.

Audit Results. We interviewed the Deputy Director of Resource Management, DFAS Denver, who stated that there was an "unfinanced requirement" identified for the military retired and annuitant pay functions in the DFAS internal budget review process. The "unfinanced requirement" was for contract transition costs. The Deputy Director stated that as of March 2002 the requirement no longer existed.

Appendix C. Cost Comparison Forms

Table C-1. Military Retired and Annuitant Pay Functions Cost Comparison Form					
Line	Item Cost Factors	Cleveland	Cleveland	Denver	
		Transition	Options Years	Options Years	Total
In-House Performance Costs					
1	Personnel	\$998,351	\$270,616,825	\$9,251,342	\$280,866,518
2	Material & Supply	10,292	1,884,642	0	1,894,934
3	Other Specifically Attributable				
	Depreciation	0	0	0	0
	Rent	0	0	0	0
	Maintenance and Repair	0	3,514,619	0	3,514,619
	Utilities	0	0	0	0
	Insurance	13,226	1,965,372	64,760	2,043,358
	Travel	0	0	0	0
	Other Costs	0	17,108,537	0	17,108,537
4	Overhead	119,802	32,474,019	1,110,161	33,703,982
5	Cost of Capital	6,845	0	0	6,845
6	One-Time Conversion	0	0	0	0
7	Additional Costs	894,560	26,588,873	0	27,483,433
8	Total In-House costs	2,043,076	354,152,887	10,426,263	366,622,226
Contract or Inter-Service Support Agreement (ISSA)					
Performance Costs					
9	Contract or ISSA Price				346,432,288
10	Contract Administration	529,809	9,826,945	0	10,356,754
11	Additional Costs	0	0	0	0
12	One-Time Conversion Costs	650,304	0	22,760	673,064
13	Gain on Assets	0	0	0	0
14	Federal Income Tax (Deduct)				2,771,459
15	Total Contract or ISSA Costs (Lines 9 + 10 + 11+ 12 - 13 - 14)				354,690,647
Decision					
16	Minimum Conversion Differential	1,445,573	10,000,000	925,134	10,000,000
17	Adjusted Total Cost of In-House Performance	2,043,076	354,152,887	10,426,263	366,622,226
18	Adjusted Total Cost of Contractor Performance (Lines 15 + 16)				364,690,647
19	Decision - Line 18 Minus Line 17				(1,931,579)
20	Cost Comparison Decision: Accomplish Work				
	In-House (+)				
	Contract (-)				(1,931,579)

**Table C-2. Military Retired and Annuitant Pay Functions
Cost Comparison Form With Economic Price Adjustments**

Line Item	Cost Factors	Cleveland Transition	Cleveland Options Years	Denver Options Years	Total
In-House Performance Costs					
1	Personnel	\$998,351	\$242,501,167	\$9,121,570	\$252,621,088
2	Material & Supply	10,292	1,884,642	0	1,894,934
3	Other Specifically Attributable				
	Depreciation	0	0	0	0
	Rent	0	0	0	0
	Maintenance and Repair	0	3,514,619	0	3,514,619
	Utilities	0	0	0	0
	Insurance	13,226	1,768,562	63,851	1,845,639
	Travel	0	0	0	0
	Other Costs	0	17,108,537	0	17,108,537
4	Overhead	119,802	29,100,140	1,094,588	30,314,530
5	Cost of Capital	6,845	0	0	6,845
6	One-Time Conversion	0	0	0	0
7	Additional Costs	894,560	26,588,873	0	27,483,433
8	Total In-House costs	2,043,076	322,466,540	10,280,009	334,789,625
Contract or Inter-Service Support Agreement (ISSA)					
Performance Costs					
9	Contract or ISSA Price				346,432,288
10	Contract Administration	529,809	9,826,945	0	10,356,754
11	Additional Costs	0	0	0	0
12	One-Time Conversion Costs	650,304	0	22,760	673,064
13	Gain on Assets	0	0	0	0
14	Federal Income Tax (Deduct)				2,771,459
15	Total Contract or ISSA Costs (Lines 9 + 10 + 11+ 12 - 13 - 14)				354,690,647
Decision					
16	Minimum Conversion Differential	1,445,573	10,000,000	824,609	10,000,000
17	Adjusted Total Cost of In-house Performance	2,043,076	322,466,540	10,280,009	334,789,625
18	Adjusted Total Cost of Contractor Performance (Lines 15 + 16)				364,690,647
19	Decision - Line 18 Minus Line 17				29,901,022
20	Cost Comparison Decision: Accomplish Work				
	In-House (+)				29,901,022
	Contract (-)				

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Deputy Under Secretary of Defense (Installations and Environment)
Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

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

Other Defense Organizations

Director, Defense Finance and Accounting Service

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (cont'd)

House Committee on Government Reform

House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform

House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform

House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Honorable Dennis J. Kucinich, U.S. House of Representatives

Deputy Under Secretary of Defense (Installations and Environment) Comments



ACQUISITION,
TECHNOLOGY
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

January 17, 2003

MEMORANDUM FOR MR. HENRY F. KLEINKNECHT

SUBJECT: Report on the Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions (Project No. D2002CH-0074)

This memorandum responds to your request for comments on the subject report. We have reviewed the subject audit report and the recommendations for the Deputy Under Secretary of Defense (Installations and Environment) (DUSD(I&E)).

We generally concur with the following recommendations at paragraph A.2. in the report.

Recommendation A.2.a. Issue guidance to the DoD A-76 community clarifying how to properly determine whether economic price adjustments (EPA) apply to personnel positions that are subject to the Service Contract Act and emphasize the importance of correctly apply the economic price adjustment in the in-house cost estimate.

ODUSD(I&E) Response: We agree that the policy for applying inflation must be improved. However, the ultimate responsibility for accuracy is not on the technicians but on government officials who sign the cost comparison form certifying the accuracy of the government cost estimate. As stated in your report, our analysis has resulted in a similar recommendation to OMB when they revised OMB Circular A-76. We suggested to OMB that they consider that economic price adjustments for government employee positions be based on the applicability of the Fair Labor Standards Act not the Service Contract Act, which is applicable only to the private sector. We plan to begin our update to DoD's A-76 related regulations when OMB publishes the revised Circular.

Recommendation A.2.b. Modify the DoD A-76 costing software used for cost comparisons to include an explanation of how the most efficient organization will be adjusted for inflation when "yes" or "no" is selected for the economic price adjustment determination.

ODUSD(I&E) Response: The DoD A-76 costing software (win.COMPARE²) currently has four separate features or check points for flagging or assisting with economic price adjustment designations. When we update the software based on the requirements in the revised Circular, additional improvements will be investigated.



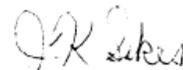
We do not support the following recommendations at paragraph B. in the report. We are comfortable with the compromise used by OMB to arrive at the 12% factor. We believe it is a fair estimate that standardizes the approach for calculating overhead. Since 1996, when OMB issued the 12% overhead policy, no DoD Component has pursued the use of a different rate. A study of such costs is as likely to result in a higher rate as in a lower rate.

Recommendation B.1. Perform a study to identify and quantify those overhead costs that are affected by the conversion from in-house to contractor performance and, in conjunction with the Office of Management and Budget, clarify guidance so that unaffected overhead costs will not be included in operations and general and administrative overhead costs.

ODUSD(I&E) Response: During development of the revised Circular, we discussed with OMB the DoD(IG)'s concerns regarding the overhead factor and the guidance in the current Circular. The results of these discussions are reflected in the proposed revision to the Circular Issued in the Federal Register on November 14, 2002. In the near future, our emphasis and efforts will be focused on the development of DoD's policies and procedures to implement the significant changes in the Circular.

Recommendation B.2. Either develop a supportable rate for DoD operations and general and administrative overhead or develop alternative methodologies that permit activities to compute reasonable overhead cost estimates instead of using the standard 12 percent cost factor in Office of Management and Budget Circular A-76 cost comparison studies, and submit to the Office of Management and Budget for approval and use.

ODUSD(I&E) Response: We will consult with DFAS to determine if a study is feasible or an alternate approach to determine the overhead factor for purposes of public-private competition. Any such study would require working with OMB, an approach consistent with the overhead policies stated in the revised Circular, and the development of a single DoD overhead rate to be used by all DoD Components. Since OMB implemented the 12% overhead rate in 1996, no DoD Component has approach us with to use either a different percentage rate or another method to calculate overhead. Based on our past experiences with non-standard rates or calculations, we would not support a non-standard DoD overhead rate or method to calculate overhead.



Joseph K. Sikes
Director, Competitive Sourcing
and Privatization

cc:
Director, DFAS

Defense Finance and Accounting Service Comments



DEFENSE FINANCE AND ACCOUNTING SERVICE

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JAN - 9 2003

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Report on the Public/Private Competition for the Defense Finance and Accounting Service Military Retired and Annuitant Pay Functions (Project No. D2002CH-0074)

The Defense Finance and Accounting Service (DFAS) has reviewed the subject report and concurs with the findings with the exception noted below:

The A-76 Cost Comparison process relies significantly on estimates and cost factors in order to compare the cost of public versus private performance of commercial activities. While the result of a cost comparison provides agencies with a basis upon which to make an award, the government's proposal is not an absolute statement of the actual costs of performance. DFAS concurs with the DoDIG computation for the decrease in the in-house cost estimate. However, we do not think it is possible to calculate the actual savings that a different competitive outcome would have produced. Therefore, we request the specific savings estimate be deleted from the report.

The following comments address the specific recommendations applicable to DFAS:

A.1.a: Concur. DFAS will evaluate all available options and decide a future course of action for the military retired and annuitant pay contract that is cost effective and provides the best service possible to our retired military and annuitant pay customers. The evaluation will be made as each contract option year is considered.

A.1.b: Concur. DFAS will review available legal options and determine appropriate actions. Estimated date of completion is February 28, 2003.

A.1.c: Concur. The USD(Comptroller) directed a review of the DFAS A-76 Cost Comparison process in a memorandum dated September 13, 2002. DFAS provided a report to the USD(Comptroller) on October 1, 2002 that addressed the scope of the review, improvements implemented, areas identified for further improvement, and estimated dates of completion for pending action. The review included all aspects of the retired and annuitant pay cost comparison. The monthly updates will be provided to the USD(Comptroller) until all actions are completed. Estimated date of completion for all actions is February 28, 2003.

A.1.d: Concur. DFAS will provide specific training to all affected participants on how to determine whether positions are subject to an economic price adjustment and the impact of the adjustment on computing personnel costs. DFAS has updated the Lessons Learned database and developed a Management Plan Certification Checklist and a DFAS Pre-Independent Review

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requirement to ensure the economic price adjustment is properly applied. DFAS will monitor the continuing training requirement and considers this recommendation completed.

C.1: Concur. DFAS will rewrite the performance requirements summary to include all mission critical services defined in the performance of work statement. Estimated date of completion is March 31, 2003.

C.2: Concur. DFAS will develop the requirements for a solicitation for a benchmarking study in the call management area. Development of the solicitation will be completed by March 31, 2003. DFAS also will clearly define what constitutes a pay problem and develop a methodology to measure performance against the standard. Estimated date of completion is March 31, 2003.

C.3: Concur. Renegotiation of the performance requirements summary will commence immediately after the results of the benchmarking study referenced in C.2. are received and approved. Completion should occur within 60 days of commencement of negotiations. However, all changes to the performance requirements summary, which include changing standards, adding performance criteria, or changing the characterization of the nature of the criteria, are subject to negotiation with the contractor and the results of cost benefit analysis.

My staff and I are available to discuss our comments if you desire. For additional information, please have your staff contact Mr. James Chittick at (703) 607-5176.



Thomas R. Bloom
Director

Team Members

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

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