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UNITED STATES GENERAL ACCOUNTING OFFICE
REGIONAL OFFICE
502 U S CUSTOMHOUSE 2D AND CHESTNUT STREETS
PHILADELPHIA, PENNSYLVANIA 19106

June 30, 1971

Commanding Officer
U.S. Navy Ships Parts Control Center
Mechanicsburg, Pennsylvania 17055

Dear Sir:

We have reviewed the pricing of 5-inch 38 caliber MK 52 MOD 0 projectiles purchased under noncompetitive firm fixed-price contract N00104-67-C-0084, which was awarded by the U.S. Navy Ships Parts Control Center (SPCC) to Lansdowne Steel and Iron Company, Morton, Pennsylvania. Our review was directed primarily toward determining the reasonableness of the price negotiated in relation to cost or pricing data available to the contractor at the time of negotiation. We also reviewed the Government's technical and audit evaluations of the contractor's proposal.

Our review showed that the final contract price of $4,751,815 was about $164,000 higher than justified by cost or pricing data available at the time of negotiation. About $131,500 of the over-pricing resulted because Lansdowne failed to disclose to the Government negotiator that (1) the cost of steel purchased during performance under letter contract -0084 was lower than the cost included in the pricing proposal, (2) the proposal included costs for pallets not to be furnished by the contractor, and (3) the proposal included overstated labor costs based upon an inaccurately calculated estimate of labor hour requirements. We believe that the Government's technical and audit evaluations lacked sufficient depth to identify these deficiencies in the contractor's proposal. The balance of the overpricing, amounting to about $32,500, occurred because the Government negotiator did not attempt to negotiate a reduction in the option quantity unit price for a start-up labor cost provision not required for the additional units.

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The following tabulation shows the overpricing attributable to each of the matters noted above.

	Overstated costs	Manufacturing overhead	G & A	Profit	Total
Steel raw material	$26,628	-	$ 3,728	$ 2,550	$ 32,906
Unnecessary pallets	17,069	-	2,390	1,635	21,094
Labor hour requirements	29,328	$33,434	8,787	6,010	77,559
Unnecessary start-up labor	12,290	14,011	3,682	2,519	32,502
Overpricing	$85,315	$47,445	$18,587	$12,714	$164,061

In addition we noted another matter which we believe had an adverse effect on the contract pricing. The proposal included an estimated provision for miscellaneous direct material. The Government's technical and audit advisory agencies accepted the estimate without requiring specific support or explanation from the contractor. Had either the technical analyst or auditor questioned this item in relation to prior cost experience, the negotiator would have been in a position to challenge about $100,000 of the basic cost provision included.

BACKGROUND

Contract -0084 was the second of three contracts awarded by SPCC to Lansdowne for the MK 52 projectile during the period February 1966 through October 1968. Delivery under the first contract (N104-11119A) which provided for production of 48,750 units, was completed in March 1967 prior to negotiation of contract -0084.

SPCC awarded letter contract -0084 to Lansdowne on January 13, 1967, for the production of 103,450 MK 52 projectiles. Lansdowne submitted a price proposal of $30.30 per projectile on February 17, 1967. The Defense Contract Administration Services (DCAS) performed a technical evaluation, and the Defense Contract Audit Agency (DCAA) audited the contractor's price proposal. Negotiations held at SPCC on April 13, 1967, reduced the price to $29.86 for a total definitive contract price of $3,089,017. The price decrease was the result of a negotiated profit rate reduction from 10 to 8.4 percent.

The contractor executed a Certificate of Current Cost or Pricing Data on April 13, 1967, and a defective pricing clause was incorporated into the contract.

The contract contained an option clause for additional quantities at the same unit price. SPCC exercised the option on May 6 and August 30, 1967, for 51,725 additional units. On April 18, 1968, the contract was amended to include 5,000 substandard projectiles at $23.50 each. The final price of contract -0084, including all modifications, was $4,751,815.

RESULTS OF REVIEW

Details on the overpricing and the Government's technical and audit reviews are as follows:

Lower costs for steel raw material

Lansdowne, in its proposal, costed each pound of steel at $0.069150. Based on an estimated steel requirement of 69 pounds per projectile, the contractor proposed a steel cost of $4.77 for each projectile. The proposed quantity and price of steel were accepted by the Government.

But, prior to negotiations, Lansdowne was buying steel from two sources at $0.065925 and $0.068875 per pound under purchase orders dated January 27, 1967, for 1,800 and 600 tons of steel, respectively. This represented about 67 percent of initial contract -0084 requirements. The difference in the cost of steel supplied by the two vendors was attributable to higher freight costs on one vendor's shipments.

In ascertaining the price effect on the contract price, we compared the proposed cost per pound with a weighted average of the costs experienced for quantities ordered prior to negotiations. Overpricing of steel was calculated as follows:

Cost of steel raw material per pound	
--proposed and negotiated	$0.069150
--per current cost data available prior to negotiations	0.066663
Excess of negotiated over current cost per pound	$0.002487
Quantity of steel included in total contract quantity	x 10,707,075 lbs.
Overpricing (exclusive of general and administrative expense and profit)	$26,628

We found that DCAA had based its acceptance of proposed steel costs on current invoices from the higher priced source. There was no evidence that the contractor had disclosed current lower cost data relating to steel being purchased from the other source. The contractor contends that the proposed steel costs included a contingency of approximately $6 per ton for price increase and quality variations. However, the contractor's proposal did not identify this contingency, nor did we find evidence that the contractor had disclosed this contingency to DCAA.

Cost for pallets not to be furnished by the contractor

Lansdowne's proposal included costs of $0.11 per unit for pallets to be used for shipment of the finished projectiles. These costs were not justified because pallets were to be furnished by the Government

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under contract -0084. However, the proposed pallet costs were not deleted from the contract price at negotiations. The amount of overpricing is calculated as follows.

Cost of pallet material per projectile	$0.11
Total contract quantity	x 155,175 units
Overpricing (exclusive of general and administrative expense and profit)	$17,069

The contractor stated that the negotiated price reduction included the deletion of proposed pallet costs. However, the contractor provided us no documented basis for its position. SPCC's record of negotiation contains no evidence that pallet costs had been deleted from the contract price. The SPCC negotiator informed us that all costs were accepted as proposed. The only reduction was in the profit rate, which was reduced from 10 to 8.4 percent.

DCAA's audit report contained no comment concerning the unnecessary pallet costs.

The technical analysis report contained the following statement concerning the inclusion of pallet costs in the contractor's proposal.

> "It is noted that contrary to the requirements of the letter order the Navy has been unable to provide pallets and/or plugs for the nose of the projectile in sufficient quantity to support the contractor's production or in satisfactory condition for use."

According to the DCAS analyst, this statement was intended to take exception to the inclusion of the pallet costs. In our opinion, this statement could have been construed as an acceptance of the pallet costs.

Lower labor hour requirements

Lansdowne proposed labor at $6.75 per projectile based upon a requirement of 2.50 labor hours at a projected hourly rate of $2.70. The labor requirement consisted of 2.33 production hours and 0.166 start-up hour, for a total of 2.496 hours rounded to 2.50 hours. The start-up hours were required to establish a second shift operation.

In its calculations of labor provisions, which were based largely on costs being incurred on the preceding contract, the contractor used values which resulted in an overstatement of start-up hours and an understatement of production hours. Our review showed that labor per projectile should have been 2.430 hours, consisting of 2.342 production hours and 0.088 start-up hour. The net effect, after considering the understatement, resulted in overpricing calculated as follows:

Labor hours required per projectile	
--proposed and negotiated	2.50
--per adjusted cost data	2.43
Overstated labor hour	0.07
Hourly rate negotiated	x $2.70
Overstated labor cost per projectile	$0.189
Total contract quantity	x 155,175 units
Overpricing (exclusive of manufacturing overhead, general and administrative expense, and profit)	$29,328

We discussed the results of our review with a Lansdowne official who agreed that available data indicated a per unit labor requirement of 2.430 hours. He contended that a labor hour requirement of 2.430 would have been rounded upward to 2.50 for proposal purposes. In view of the significant effect on pricing of the large multiplier, we question whether the Government negotiator would have accepted this rounding.

The DCAS technical report indicated that the analyst based his acceptance of proposed labor hour requirements on a review of operations in the contractor's plant and an examination of historical data. His report failed to disclose the discrepancies in the contractor's labor hour calculations.

We were informed by a DCAA official that no detailed review was made of the contractor's labor hour provision. Labor hours were accepted as proposed on the basis of technical advice from DCAS.

Unnecessary start-up labor costs included in option quantity price

The start-up hours, as discussed in the preceding section, were fully provided for in the pricing of the initial 103,450 units. Since continuous production was anticipated in the exercise of the option, it would have been appropriate to exclude start-up labor in pricing the option quantity. Nevertheless, the unit price negotiated for the option quantity was the same as for the initial quantity. We calculated the overpricing as follows:

Start-up hours as adjusted (see p. 4)	0.088
Option quantity	x 51,725
	4551.80
Hourly rate negotiated	x $2.70
Overpricing (exclusive of manufacturing overhead, general and administrative expense, and profit)	$12,290

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The DCAS technical analysis report identified the start-up labor requirement included in the contractor's proposal and noted that the requirement was "amortized" over the production of the initial contract quantity.

The DCAA audit report did not comment on start-up costs. We believe that DCAA should have commented on the nonapplicability of these costs to the option quantity.

It is our opinion that the information supplied by DCAS should have alerted the SPCC negotiator that the proposed unit price included costs that would not be applicable to the option quantity.

Unsupported estimate of
miscellaneous direct material costs

The contractor's proposal included a cost per projectile of $0.75 identified as "Phos. coat, paint, grease and strapping." which was purported to represent all direct materials not specified elsewhere in the proposal. According to the contractor, the amount proposed was an estimate for which no supporting documentation was provided to the Government.

Neither the technical report nor the audit report included any comments on the reasonableness of the requirement or cost for these items. The technical analyst stated only that the bill of material included quantities for paint and packing materials. The auditor, without elaboration, noted that these costs were estimated on a judgment basis. The auditor's working papers contained no information to show that he had attempted to ascertain the reasonableness of the contractor's estimate.

A Lansdowne official informed us that neither the DCAS technical analyst nor the DCAA auditor had requested support for this estimated cost. At the time of the DCAA audit, the contractor had segregated miscellaneous direct material costs of less than $0.03 per unit for projectiles shipped under preceding contract -11119A, which was then 80 percent complete. Lansdowne's treasurer contended that the firm's cost accounting system did not at that time allocate miscellaneous material costs accurately enough to be used for cost estimating.

We recognize that recorded costs for contract -11119A may not have accurately set forth miscellaneous material requirements. However, it is our opinion that had the DCAA auditor reviewed these costs, he would have been in a position to request documentation for the estimate or to alert the SPCC negotiator to the need for additional substantiation.

A Lansdowne official stated that during preparation of the proposal for succeeding contract N00104-69-C-0095, they recognized that the estimate of $0.75 per unit for contract -0084 was overstated. As a result, miscellaneous direct material costs of $0.11 per unit were proposed on the basis of recorded contract -0084 cost experience. A comparison of the proposed costs for contract -0084 and contract -0095 suggests that the former was overstated by about $99,000 excluding general and administrative expense and profit.

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We recommend that SPCC procurement officials consider the matters reported, along with any additional information available, to determine the Government's legal entitlement to a price reduction with respect to contract -0084.

We would appreciate being advised of actions taken or contemplated with regard to the matters presented in this letter.

Copies of this letter are being sent to the following:

Commander, Defense Contract Administration Services Region, Philadelphia, Pennsylvania

Regional Manager, Defense Contract Audit Agency, Philadelphia, Pennsylvania

Lansdowne Steel and Iron Company, Morton, Pennsylvania.

Sincerely yours,

Milton H. Harvey

Milton H. Harvey
Acting Regional Manager

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