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REPORT TO THE CONGRESS

Improvements Still Needed In
Negotiating Prices Of Noncompetitive
Contracts Over \$100,000 B-168450

Department of Defense

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This is our report on improvements needed in negotiating prices of noncompetitive contracts over \$100,000 in the Department of Defense.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget; the Secretaries of the Navy, Army, and Air Force; and the Director, Defense Supply Agency.

A handwritten signature in black ink, reading "James B. Stacks".

Comptroller General
of the United States

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ABBREVIATIONS

ACO	administrative contracting officer
ASPR	Armed Services Procurement Regulation
DCAA	Defense Contract Audit Agency
DCAS	Defense Contract Administration Services
DOD	Department of Defense
DSA	Defense Supply Agency
GAO	General Accounting Office
PMR	procurement management review
SAMSO	Space and Missile Systems Organization

COMPTROLLER GENERAL'S
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IMPROVEMENTS STILL NEEDED IN
NEGOTIATING PRICES OF
NONCOMPETITIVE CONTRACTS
OVER \$100,000
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D I G E S T

WHY THE REVIEW WAS MADE

DOD contracts over \$100,000 for fiscal years 1972 and 1973, negotiated on a noncompetitive basis, totaled about \$19.4 billion and \$17.7 billion respectively, about 54 and 53 percent of total awards.

Because of these significant dollar amounts, GAO reviewed a random sample of DOD's noncompetitive procurements to obtain an overall evaluation of DOD's performance in negotiating noncompetitive contracts.

GAO selected 183 contracts, valued at about \$2.1 billion, awarded by 39 of DOD's approximately 220 procurement offices. (See p. 30.)

The review required a test of DOD's implementation of its procurement procedures and management control practices. (See p. 30.)

FINDINGS AND CONCLUSIONS

Although DOD's procurement offices generally are effective in negotiating noncompetitive contracts, improvements, both in practices followed by the procurement offices and in management controls, are needed. Improvements that will result in greater assurance that contract prices are fair and reasonable include the following:

Improvements needed in
obtaining cost or pricing data

The 183 contracts included about \$1.9 billion of proposed or negotiated cost. About \$301 million, or 15 percent of the total cost examined, was not supported, to the extent required by the Armed Services Procurement Regulation, by cost or pricing data. (See p. 4.)

There was no record that contracting officers had determined that the cost or pricing data submitted or identified met established criteria. A thorough evaluation of the adequacy of the data in support of proposed costs is necessary to identify and correct deficiencies before negotiating a final price. (See p. 7.)

More information needed in
advisory reports on
contractors' proposals

Technical and financial evaluations of contractors' proposals provide a basis for establishing a price objective to be used in contract negotiations.

Overall the reports on such evaluations were of significant value to contracting officers in establishing negotiation objectives and in negotiating with the contractors. However, some of the reports

could be improved. (See p. 9.)

For example, about 24 percent of the technical evaluation reports did not adequately

--describe work performed,

--identify contractor data analyzed, or

--provide the rationale for questioning proposed costs.

Without this information the contract negotiator does not have assurance that the evaluators' conclusions are well founded or that reliance on them in contract negotiations will result in fair and reasonable prices. (See p. 11.)

In 72 instances the audit reports were qualified because the auditors did not receive the technical evaluation reports in time to compute the financial aspects of the technical findings and include them in the audit reports. (See p. 11.)

Improvements needed in price negotiation

The price negotiation memorandums prepared for 33 of the 183 contracts reviewed did not discuss some of the principal elements of the negotiation. (See p. 13.)

In addition, 53 memorandums did not contain any statements on the Government's reliance on cost or pricing data submitted by the contractor. Regulations currently require only that the extent of nonreliance on the data be cited.

When contractors formally submit data to the contracting officer or other Government personnel, a record of the data submitted or identified is available for review. Contractors, however, may informally submit additional data during reviews or evaluations by Government personnel or during negotiation.

The lack of formal identification of this data and the reliance placed on it in establishing a price can have an important effect on the Government's right to a price reduction when defective data was submitted and relied on during negotiations. (See p. 14.)

If contracting officers stated in the negotiation memorandum whether they did not rely on any data submitted with the contractor's proposal and identify any additional data relied on which was submitted thereafter, a record would be available for reviewing authorities and for determining whether defective data had been relied upon. (See p. 14.)

In 23 cases the contracting officers did not furnish copies of the negotiation memorandums to the auditors or the administrative contracting officers, though required. (See p. 15.)

Procurement office reviews could be more effective

To insure that procurement policies and procedures are being followed, procurement offices

perform independent supervisory reviews of contract actions. These reviews are beneficial to management, but they could be more useful if they were performed in greater depth in areas where problems are likely to occur, such as those discussed in this report. (See p. 17.)

Improvements needed in management controls

DOD, the services, and the Defense Supply Agency have internal control and surveillance groups. Management uses the resources of these groups, in part, to assure themselves that procurement offices are following practices required for effective pricing of noncompetitive contracts.

GAO reviewed the activities of two of those groups--procurement management review and internal audit of DOD, the services, and the Defense Supply Agency.

Of the 39 procurement offices visited, 19 had been reviewed by either the procurement management review or internal audit groups or both, during fiscal year 1972. The reports prepared by these groups indicate that the procurement offices are doing an effective job, but that some weaknesses recur despite improvement efforts.

Major recurring deficiencies relate to inadequate cost or pricing data and technical evaluations. Although some effort is spent by these groups to follow up on the implementation and effectiveness of recommendations, these followups are not directing sufficient attention to recurring problems after corrective action has been attempted. (See pp. 21 and 22.)

RECOMMENDATIONS

The Secretary of Defense should improve the implementation of procedures established to insure the negotiation of fair and reasonable prices for noncompetitive contracts. (See pp. 25 and 26.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

DOD, in commenting on GAO's recommendations, said that it subscribes to the basic thrust of the recommendations.

DOD said that five of the recommendations would be referred to the military services and the Defense Supply Agency as examples of matters of concern in their efforts to improve the procurement process within their organizations. Since such referral might not place sufficient emphasis on the matters involved, GAO believes that the Secretary should consider these recommendations in a planned revision of the Manual for Contract Pricing. (See p. 27.)

DOD said that it was not persuaded that any benefit would be derived from GAO's recommendation that contracting officers be required to determine and record whether or not adequate cost or pricing data had been obtained from the contractor in the form and substance required by regulation.

DOD contended that judgment plays a large part in determining what is adequate data and that differences of opinion are likely to arise. (See p. 27.) GAO believes that judgment had little to do with the

failure of Agency officials to obtain adequate data submissions. Rather, it appeared that no official had assumed the responsibility to determine whether the data submitted was in accordance with established criteria. GAO suggested that DOD reconsider its position on this recommendation. (See p. 27.)

In regard to GAO's recommendation that contracting officers be required to identify in the negotiation memorandum any data relied on which was submitted informally by the contractor, DOD said that it had issued a regulation dated May 26, 1972, which emphasizes the ASPR requirement that the price negotiation memorandum clearly identify submitted data that was not used or was not relied on by

the contracting officer in negotiating the contract price. (See p. 28.)

GAO explains that its recommendation is directed toward assuring that there would be a complete record of all data submitted informally that was relied on. (See p. 29.)

MATTERS FOR CONSIDERATION BY
THE CONGRESS

Although DOD is generally doing an effective job in negotiating prices of noncompetitive contracts, implementation of the improvements identified in the report will give greater assurance that prices negotiated are fair and reasonable.

CHAPTER 1

INTRODUCTION

We examined Department of Defense (DOD) practices in negotiating prices of noncompetitive contracts over \$100,000. We wanted to find out how DOD procurement offices complied with policies and procedures to insure that prices negotiated under noncompetitive conditions were fair and reasonable.

A significant portion of DOD's contracts have been negotiated on a noncompetitive basis. For fiscal years 1972 and 1973, noncompetitive awards of \$100,000 or more totaled about \$19.4 billion and \$17.7 billion, respectively, or about 54 and 53 percent of total awards. These totals include fixed price and cost type definitive contracts and contract modifications, letter contracts, funding for previously awarded contracts, and termination settlements, as well as other miscellaneous type actions. Weaknesses in or failure to follow established policies and procedures has generally had the greatest impact on fixed price type definitive contracts and modifications.

Based on statistical data furnished by DOD, we estimated that DOD's procurement offices negotiated about 3,200 noncompetitive fixed price type definitive contracts and modifications, valued at about \$4.6 billion, during fiscal year 1972. Using random sampling techniques, we selected for review 183 of these actions with a reported value of about \$1.6 billion.¹ (See chapter 8.)

DOD'S POLICIES AND PROCEDURES

DOD's policies and procedures on pricing noncompetitive contracts for supplies and services are set forth in the Armed

¹Although our review was limited to the 183 actions initially selected, the dollar amount reviewed was \$2.1 billion rather than the indicated value of \$1.6 billion. In a number of instances, the contract values selected statistically reflected a lesser value than that examined. For example, in some instances the selected action was negotiated as part of a larger action. This necessitated review of total cost negotiated, rather than that amount associated with the selected action.

Services Procurement Regulation (ASPR), which implements the requirements of the Armed Services Procurement Act of 1947 (10 U.S.C. 2301 et seq.). The policies and procedures include (1) obtaining from the contractor cost or pricing data to support proposed costs and preparing for negotiations with the contractor and (2) conducting negotiations and preparing a record of them. In addition, to insure that DOD's policies and procedures are being properly carried out, the procurement offices review individual pricing actions and DOD, the services' and the Defense Supply Agency (DSA) procurement management review and internal audit staffs review the procurement offices' activities.

Cost or pricing data

Public Law 87-653, the Truth-in-Negotiations Act, and ASPR provide that contractors be required, with certain exceptions, to submit cost or pricing data supporting proposed prices for noncompetitive contracts and contract modifications expected to exceed \$100,000. In addition, the contractors are required to certify at the time of negotiations that the submitted data is accurate, complete, and current.

Proposal evaluation and preparation for negotiations

DOD regulations provide that cost analysis be performed when cost or pricing data is required to be submitted. Cost analysis is the review and evaluation of a contractor's cost or pricing data and the judgmental factors applied in estimating the cost of performing the contract, assuming reasonable economy and efficiency. A contract pricing team, which performs the cost analysis and evaluation of price proposals, generally includes the Defense Contract Audit Agency (DCAA), the Defense Contract Administration Services (DCAS), and other professional and technical Government personnel at the contractor's plant and the procurement office.

The contract pricing team submits written reports to the contracting officer on the reviews and evaluations. These reports are used in developing a negotiation objective.

Negotiations

Meetings are held with the contractor to discuss differences between the price proposed and the Government's negotiation objective and arrive at a final price. New

information may be introduced at these meetings which may require evaluation and a change in the negotiation objective. With or without the introduction of new information, these negotiations result in a final price which may be different from the agency's initial objective.

Because of the importance of these negotiations, ASPR requires that immediately upon completing negotiations, the contracting officer prepare or cause to be prepared a memorandum of negotiations, setting forth the principal elements considered during negotiations. If cost or pricing data was submitted and a certificate required, the memorandum must reflect the extent of nonreliance on the contractor's cost or pricing data in arriving at the final price.

The contract must include a clause which gives the Government a right to reduce the contract price if the price was increased because the contractor submitted data that was not accurate, complete, or current (defective data).

Procurement office reviews

Procurement offices generally review major procurement actions for compliance with policies and procedures for negotiating contract prices. Such reviews may be made on a preaward or postaward basis and may cover one or more contracts.

DOD's surveillance

DOD has established a number of review groups to assure management that procurement policies and procedures are being followed and to identify policies that need to be changed or adopted. Of particular significance are the procurement management review staffs and the internal audit staffs maintained by DOD, the services, and DSA.

CHAPTER 2

IMPROVEMENTS NEEDED IN OBTAINING COST OR PRICING DATA

For the 183 contract actions valued at \$2.1 billion, 85 percent of the \$1.9 billion of estimated costs were adequately supported by cost or pricing data, in the form and substance required by ASPR and the ASPR Manual for Contract Pricing. In contrast, 15 percent, or \$301 million, of these costs were not adequately supported even though in most cases some data was submitted or identified. This \$301 million related to 115 contracts involving total costs of \$900 million.

UNSUPPORTED COSTS

The contract pricing proposal form lists 15 cost elements, such as purchased parts, direct manufacturing labor, and manufacturing overhead. In presenting examples of inadequately supported costs, we combined total costs examined into six major categories: materials, subcontracts, labor, overhead, general and administrative, and other. A summary of our findings in this format follows.

<u>Cost Category</u>	<u>Cost Not Adequately Supported</u>	
	<u>Cost</u>	<u>Percent</u>
	(000 omitted)	
Materials	\$ 48,422	12.0
Subcontracts	119,330	25.1
Labor	34,571	10.4
Overhead	55,220	13.7
General and administrative	22,481	9.9
Other	<u>20,660</u>	20.7
Total	<u>\$300,684</u>	15.5

Examples by cost category follow.

Materials

The Army's San Francisco Procurement Agency awarded a \$5.8 million contract for cartridge cases that included material costs of \$1.4 million. About \$1.2 million of this amount was not supported by adequate cost or pricing data. For one type of material, steel plate, the contractor identified the basis for unit cost but did not identify the basis for the quantity required. Other material costs were identified as based on standard costs, but no data was presented or identified to show how the standard costs were established or the basis for adjustment factors applied to the standard costs to arrive at proposed costs.

In its letter of May 24, 1974, (see app. III), DOD commented on this example.

DOD said that its review indicated that the data available was sufficient and in accord with policy requirements. Specifically, DOD stated that the contractor disclosed the steel plate to be used, its price per pound, the pounds required, and identified the price increases of steel since award of a predecessor contract. DOD also stated that the agency auditor took no exception to material, noting that the steel price was based on a catalog price effective on the same date identified by the contractor as the most recent steel price increase.

We agree with DOD that the above information was made available to the contracting officer. However, except for the basis of the price of steel plate, this information does not fulfill specific requirements for cost or pricing data established by ASPR and the ASPR Manual for Contract Pricing.

The material cost proposed by the contractor apparently consisted of several types of materials. Basic material costs were adjusted for spoilage and material variances. The contractor identified the quantity and price of the steel plate, but did not disclose the source of this information or data to support other material quantities, prices, and variances. The auditor, technical analyst, and price analyst furnished the contracting officer additional supporting information but did not adequately identify how the contractor determined the types and quantities of all materials proposed, the method of pricing all of the materials, or the basis for estimating spoilage and variance factors.

Some of the data furnished by these officials were contradictory. For example, as DOD states, the auditor noted that the proposed steel prices were based on catalog prices. The price analyst, however, stated that material costs were principally based on historical data and new quotations. As a result, there was no clear identification of the cost or pricing data submitted and certified by the contractor in support of the proposed price.

Subcontracts

The Air Force Electronic Systems Division awarded a contract which included a noncompetitive subcontract estimate of about \$515,000. The prime contractor supported this cost estimate with a firm quote furnished by a prospective subcontractor. The prime contractor, however, did not obtain and submit to the contracting officer, though required, subcontractor cost or pricing data to support the quote. DCAA's audit report on this proposal did not show what data, if any, had been furnished to the auditor to support the subcontractor's quote.

Labor

The Naval Electronic Systems Command awarded a \$1.1 million contract for electrical equipment shelters that included about \$146,000 for manufacturing labor costs. Although the contractor stated that the labor hours were based on prior experience, the experience data used to develop the estimate was not identified. The contractor stated that a composite labor rate was used but did not reveal how the rate was developed.

Overhead

The Army Corps of Engineers, Huntsville Division, awarded a contract for a shock test program. The contract price included overhead costs of \$260,000. Although the contractor's submission disclosed that this amount was computed by applying three overhead rates to certain direct labor costs, the

contractor did not submit data showing the basis for the rates.

General and administrative

The Defense Construction Supply Center, DSA, awarded a \$4.4 million contract for fire extinguishing foam which included \$205,000 for general and administrative costs. The proposal stated that general and administrative costs were based on projected costs for a particular year. The proposal, however, did not contain data showing how the proposed amount was computed, such as the various cost elements in the general and administrative pool or the base for allocation.

Other costs

The Naval Ordnance Systems Command awarded a \$9.8 million contract for gun mounts. This amount included other costs of about \$527,000, represented as being 6 percent of total production costs. Although the contractor explained that the rate was based on a mathematical projection of historical relationships between other costs and production costs under a specific contract, data in the records at the procurement office was not adequate to permit a reasonable understanding or reconstruction of the mathematical projection.

REASONS FOR NOT OBTAINING REQUIRED DATA

We believe that, for most of the cases examined, the contracting officers were not aware that adequate data had not been obtained. DCAA or the price analyst generally determined whether sufficient data had been obtained upon which to conduct negotiations with the contractor. We found no instance, however, of a written determination that cost or pricing data obtained, either directly or indirectly from the contractor, met the criteria ASPR and the ASPR Manual for Contract Pricing established.

A determination of whether adequate cost or pricing data has been submitted is complicated because data is furnished not only to the contracting officer but also to members of the pricing team, such as DCAA, DCAS, or other technical or administrative personnel, and not all such data is consolidated into one package. An objective evaluation of all data

submitted is necessary, however, to identify and correct deficiencies in the data before negotiating a final price.

CONCLUSIONS

Obtaining sufficient cost or pricing data from contractors to clearly support and identify the basis for proposed or negotiated cost has been a problem since the enactment of Public Law 87-653. To resolve this problem, DOD, in 1969, included in the ASPR Manual for Contract Pricing a detailed explanation and examples of what constitutes an adequate submission of cost or pricing data. The results of our random sample indicate that this manual, as well as other actions, may have gone a long way to resolve this problem. Of the costs examined, 85 percent were adequately supported by cost or pricing data.

On the other hand, since 15 percent of the cost examined was not adequately supported, further improvements are needed. The absence of adequate cost or pricing data not only creates doubt as to the reasonableness of prices negotiated but also may limit the Government's rights under the defective pricing clause.

We reported to the Secretary of Defense in March 1973 that contracting officials were determining that they did not have an adequate basis to reduce contract prices in the amounts recommended by DCAA on the basis of postaward audits which indicated that contractors had submitted cost or pricing data that was not accurate, complete, or current. One of the major factors contributing to the rejection of DCAA's recommendations was the contracting officers' failure, initially, to require contractors to submit information that identified the data, state what the data represented, and describe how the data was used in arriving at the proposed price.

RECOMMENDATION

We recommend that the Secretary of Defense require contracting officers to include in the memorandum of negotiations a statement whether cost or pricing data has been obtained from the contractor in the form and substance required by ASPR, and, if not, explain why.

CHAPTER 3

MORE INFORMATION NEEDED IN

ADVISORY REPORTS ON CONTRACTORS' PROPOSALS

Technical and financial evaluations of contractors' proposals are performed to aid the contracting officer in establishing a price objective to be used in contract price negotiations. A number of the resulting evaluation reports could have been better prepared.

Some of the technical evaluation reports did not adequately (1) describe the work performed, (2) identify the contractor data analyzed, or (3) furnish rationale for questioning proposed costs. In many instances the results of the financial audits were qualified because the results of the technical evaluations were not furnished to the auditors in time for them to compute the financial effects of the technical findings and include them in the audit reports.

In these instances, contract negotiators did not have assurance that recommendations made by the evaluators of acceptance or nonacceptance of proposed costs were well founded or that they had a complete record of the data contractors submitted or identified to support proposed costs.

Except for the above weaknesses, contracting officers and other members of the pricing team generally followed established procedures or reasonable methods in evaluating proposals and setting negotiation objectives. The evaluators' reports generally formed the basis for the negotiation objectives of all cost elements.

TECHNICAL EVALUATION REPORT DEFICIENCIES

Of the 154 technical evaluation reports reviewed, 37 or 24 percent, did not adequately describe the scope and depth of work performed or identify the specific data analyzed. Further, 18 of these reports did not cite sufficient data and rationale to support exceptions taken to the proposal. An example follows.

A contractor proposed 89,480 manufacturing and engineering labor hours, estimated at about \$570,000, to produce

material for the fleet ballistic missile program. The technical evaluation report prepared by engineers of the procuring activity, the Naval Ordnance Systems Command, questioned 15,028 of the proposed hours, involving about \$106,000. The scope and depth of work performed were not described and the basis for the questioned hours was not mentioned. The report stated that the contractor was experiencing serious engineering and technological problems requiring substantial research and had submitted a revised proposal adding 5,796 labor hours for the added effort. The report does not indicate whether the revised proposal was evaluated. However, the evaluator recommended the acceptance of the originally proposed hours, including the questioned hours as an offset to the labor hours for the added research, without explaining the work performed to establish the reasonableness of the additional hours.

Similar deficiencies were discussed in our August 5, 1968, report to the Secretary of Defense on the need for improvements in price negotiations of defense contracts (B-39995). That report stated that technical evaluation reports lacked adequate explanations of the conclusions and the recommendations. We recommended to the Secretary that procedures be established to require that technical evaluation reports disclose the scope of the evaluation, the methods used by the evaluators, and the basis for the conclusions reached on each significant proposal element.

The Secretary advised us that procedures were revised, effective October 1972, in accordance with our recommendations. The revised procedures state that technical evaluation reports should list reference material used by the analysts in arriving at conclusions and recommendations and provide sufficient detail to support the recommendations for each proposed cost element. The revised procedures, however, do not specifically require that the reports describe the scope of evaluation or the work performed.

The Air Force internal auditors also commented on weaknesses in technical evaluation reports after performing a review at the Space and Missile Systems Organization (SAMSO), Los Angeles, California, during 1972. The Audit Agency recommended that SAMSO establish minimum standards for technical evaluation reports, along with supervisory controls to insure that the standards are implemented.

This recommendation was concurred in by SAMSO and effective April 12, 1973, instructions were issued directing improvements in technical evaluation reports. The instructions state that technical evaluation reports should clearly delineate what was analyzed, how it was analyzed, and the basis for conclusions. All the procurements we reviewed at SAMSO preceded the new reporting requirements.

In addition, as a result of our review, the Naval Regional Procurement Office, Los Angeles, California, took action to improve the reporting of technical evaluations.

QUALIFYING STATEMENTS IN AUDIT REPORTS

ASPR requires that technical evaluation reports be furnished to the auditors at the earliest possible time, at least 5 days before the due date of the audit report, to enable the auditor to compute the financial effects of the technical findings and to include them in the audit report.

Because the auditors were not furnished the results of the technical evaluations, 72 of the 173 audit reports reviewed were qualified. For example, DCAA, in reporting on its evaluation of proposed material costs of \$1.6 million, advised the procurement agency that the report was qualified as to the quantitative and qualitative aspects of the proposed material costs because DCAA did not have the technical results.

CONCLUSIONS

Overall, the field pricing reports on the evaluation of contractors' proposals were useful to contracting officers in establishing negotiation objectives and in negotiating with contractors. Essentially all the conclusions in the audit reports and 76 percent of the conclusions in the technical reports were supported by detailed information presented in the reports. About 24 percent of the technical reports did not adequately disclose the scope of the evaluation, the analytical methods used, or data analyzed or provide sufficient data and rationale to support conclusions and recommendations.

In such cases, contracting officers did not have assurance that prices proposed were fair and reasonable and may have been handicapped in convincing the contractor of the Government's position when costs were questioned. Further, when the data

reviewed was not identified, the contracting officer may have difficulty in later determining what data, if any, the contractor certified to that was submitted informally and relied on during the evaluation.

In 72 instances the audit reports were qualified because the auditors did not receive the results of the technical evaluations of the contractors' proposals.

RECOMMENDATIONS

We recommend that, to improve the usefulness of advisory reports, the Secretary of Defense require that activities performing technical evaluations of price proposals (1) include in their reports the scope of the evaluation, the data analyzed, and the data and rationale supporting conclusions and recommendations and (2) coordinate their work to the extent feasible with those activities performing financial evaluations so that results may be exchanged promptly.

CHAPTER 4

IMPROVEMENTS NEEDED IN PRICE NEGOTIATION

For each contract, we reviewed (1) the price negotiation process to find out whether negotiation objectives were met and (2) the procurement files to see whether the price negotiation memorandums were prepared and distributed as required. We also considered whether the type of contract was appropriate, how profit was negotiated, and whether the contract included a clause for price reduction for submission of defective cost or pricing data. Most elements of the price negotiation process complied with ASPR requirements. We found two weaknesses, however, relating to negotiation memorandums.

INSUFFICIENT DETAIL IN THE PRICE NEGOTIATION MEMORANDUMS

According to ASPR, a price negotiation memorandum must be written after contract negotiations and must (1) set forth the principal elements of price negotiation, (2) be in sufficient detail to reflect the most significant considerations affecting price, (3) state why cost or pricing data was or was not required and the extent the data was not relied on, and (4) state the extent to which the contracting officer recognized that any data was inaccurate, incomplete, or noncurrent.

Of the 183 memorandums examined, 33 did not contain some of the required information. Examples follow.

1. The price negotiation memorandum for procuring guided missiles and launchers by the Army Missile Command, Redstone Arsenal, Alabama, did not set out the principal elements of price negotiation and did not reconcile the difference between the Government's negotiation objective of \$7.2 million and the negotiated price of \$9.7 million.
2. The memorandum written for procuring Minuteman motors by the Space and Missile Systems Organization did not explain why the negotiator gave the contractor a lump sum increase of \$222,000 and whether the increase was justified on the basis of

cost factors. Procurement officials said agreement to this increase was necessary because the contractor would not begin work until the increase was approved and any delay would have increased cost further by interrupting production continuity.

In addition, 53 memorandums did not state the Government's reliance on cost or pricing data submitted by the contractor. ASPR requires only that the memorandums reflect the extent to which reliance was not placed upon the data submitted. Under these conditions, it is not possible to trace, from the memorandum, what data was submitted and what was relied on.

When contractors formally submit cost or pricing data to the contracting officer or other Government personnel, a record of the data submitted or identified is available for review. However, contractors may informally submit additional data during reviews or evaluations by technical or audit personnel or during negotiations. The following example in our report to the Secretary of Defense (B-159724, Mar. 22, 1973) illustrates the harmful effect of not being able to identify what data submitted during negotiations was relied upon.

In negotiating a contract to manufacture missiles, the contractor proposed developmental labor costs of \$9 million on the basis that development labor hours would be 23 percent of the engineering labor hours as experienced under previous contracts. DCAA, however, in a postaward audit found that, at the time of the negotiations, the contractor had completed about one-half of the engineering effort and had incurred developmental labor hours which amounted to only about 10 percent of engineering labor hours. DCAA stated that the contractor had not reported this information during negotiations and recommended a price reduction of \$7 million. The contracting officer decided not to accept DCAA's recommendation because, in his opinion, the contractor had furnished this data to the Government during negotiations. We found, however, no evidence of this disclosure in the negotiation memorandum or other records.

If contracting officers were required to state in the negotiation memorandum whether they did not rely on any data submitted with the contractor's proposal and identify any

additional data relied on which was submitted thereafter, a complete record would be available for reviewing authorities and for determining whether defective data had been relied on.

LIMITED DISTRIBUTION OF THE MEMORANDUMS

In 23 cases the procurement contracting officers did not furnish copies of the negotiation memorandums to DCAA and the administrative contracting officers (ACOs), though required. In 15 instances the memorandums were sent to neither the ACOs nor DCAA; in 8 other cases the memorandums were sent to only 1 of these offices. For example, at the Army Munitions Command the memorandums were forwarded to DCAA but not to the ACO. Written procedures were developed after our review to provide for distribution of the memorandum to both DCAA and the ACO.

The memorandums are means of advising the auditor and ACO of the use of their advisory services in negotiating with the contractors and of ways these services can be improved.

CONCLUSIONS

There are some weaknesses in preparing and distributing the price negotiation memorandum. Since the memorandum is the written record of price negotiations, it should be adequate to permit reconstruction of the major considerations which occurred during the negotiation. Failure to identify data submitted informally and relied on during negotiations could present an incomplete record to reviewing authorities and could adversely affect the Government's entitlement to a price reduction when the contractor submitted defective data during negotiations that was relied on.

When the ACO and the auditor did not receive copies of the memorandum, they were not informed of the effect of their recommendations and were not afforded the opportunity to improve their advisory services.

RECOMMENDATIONS

We recommend that the Secretary of Defense:

- Emphasize that contracting officers should record in the price negotiation memorandum the principal elements of the negotiation.
- Require contracting officers to state in the memorandum whether they did not rely on any data submitted with the proposal and identify any additional data relied on which the contractor submitted thereafter.
- Insure that the memorandum is distributed to the ACO and cognizant DCAA auditor so that they may see the results of negotiations and benefit by them.

CHAPTER 5

PROCUREMENT OFFICE REVIEWS COULD BE MORE EFFECTIVE

At the procurement offices where we examined five or more procurement actions, we inquired how management assures itself that procurement policies and procedures are followed. Generally, management provided for one or more levels of review, independent of the contracting officer, of each contract action. These reviews are beneficial to management; however, they could be more effective if they were made in greater depth in those areas where problems are likely to occur, such as those discussed in the preceding chapters.

The type or level of review generally relates to the dollar value of the individual contract action. For small procurements, reviews may be limited to scrutiny by section or department heads, independent of the contracting officer. Larger value actions are given more attention by higher level personnel. Examples of procurement office review procedures follow.

The Air Force's Space and Missile Systems Organization provides for two levels of review. For contract actions valued between \$100,000 and \$500,000, reviews are generally performed by the Director of Procurement and Production of the system program office. All contract actions of \$500,000 or more are reviewed and approved by a Procurement Committee composed of two types of personnel. Senior reviewers, generally former contracting officers, examine the actions from a business viewpoint. Administrative reviewers, generally former procurement clerks, review the contract files to see that all required clauses are included in the contract and that regulations are complied with.

The Army's Aviation Systems Command provides for review by award boards of all negotiated contract actions over \$10,000. Award board "A" reviews all proposed awards of \$500,000 and over. Award board "B" reviews all proposed awards between \$10,000 and \$500,000. Members of this board may be of lower rank or grade than those serving on the "A" board. The Chief, Policy and Compliance Division, Directorate for Procurement and Production, or his alternate, chair both of the boards.

The commanding general appoints the chairman and board members. Membership includes qualified representatives from legal, production, technical, contract pricing, and such other groups as may be appropriate. These boards are responsible for determining whether the proposed award represents a sound business transaction and all applicable provisions of the procurement regulations and other procedural requirements have been satisfied.

DEPTH OF REVIEWS INADEQUATE

Although many of the contract actions reviewed were subjected to some type of review independent of the contracting officer, a significant number of these actions, as described in the preceding chapters, were not in full conformance with policies and procedures. As discussed in chapter 2, 115 actions were not adequately supported by cost or pricing data. Examples of procurement deficiencies not questioned by reviewers follow.

1. At the Air Force's San Antonio Air Materiel Area, reviewers used a Quality Checklist as an aid to insure consideration of all major aspects of the procurement. This checklist covered 67 items, including consideration of whether (1) a technical evaluation and audit had been obtained, (2) the evaluation and audit reports were included in the contract file, and (3) the file contained complete and trackable cost or pricing data to support the contractor's proposal. Despite the apparent completeness of the coverage, we found that, for one of the five actions our staff reviewed, over 60 percent of the negotiated cost was not adequately supported by cost or pricing data.
2. A supervisory review was made of a technical field services contract at the Naval Air Engineering Center. We found no evidence that the ASPR Manual for Contract Pricing was used as a basis for determining whether the cost or pricing data submitted was complete. On this basis, we considered data supporting about \$500,000, or 59 percent of the total negotiated cost, to be incomplete.

3. At the Army Munitions Command, supervisory officials and a review board reviewed a contract for rocket fuzes. Nevertheless, \$1.7 million, or about 99 percent of the negotiated cost, was not adequately supported by cost or pricing data. In addition, the technical report did not contain support for the evaluator's recommendations.

CONCLUSIONS

Procurement office reviews of compliance with policies and procedures are beneficial but can be improved. In many instances these reviews have not been of sufficient scope or depth to disclose deficiencies in applying prescribed policies and procedures. Had these matters been identified by the procurement office reviews, timely corrective action could have been taken.

RECOMMENDATION

We recommend that the Secretary of Defense emphasize to procurement offices the importance of their review in insuring that policies and procedures are followed.

CHAPTER 6

IMPROVEMENTS NEEDED IN MANAGEMENT CONTROLS

We examined also the management controls, established by DOD, the military services, and DSA to insure that procurement policies and procedures were followed. Many internal audit and surveillance groups have been established within DOD and the services. As part of their mission or responsibilities, many of these groups perform reviews and surveillance of activities related to pricing noncompetitive contracts.

Our examination was limited to two of these organizations, the procurement management review (PMR) and internal audit groups of DOD, the services, and DSA.

Generally, these review groups were providing management with considerable input on the efficiency and effectiveness of procurement, including the pricing of noncompetitive contracts. Within the period our review covered, these groups conducted some procurement or pricing reviews and recommended correction of problems and weaknesses. However, the benefits derived from their reviews could be increased by providing for a systematic and coordinated followup on implementation of recommendations to correct deficiencies. A number of these deficiencies were similar to those discussed in this report.

PROCUREMENT MANAGEMENT REVIEWS

A Defense Procurement Management Review Program, established by DOD in 1962 and revised in 1966, provides that DOD, the military departments, and DSA maintain PMR staffs at the headquarters level and submit reports directly to officials at the assistant secretary level. The primary emphasis is on independent reviews aimed at improving procurement performance by identifying and solving basic problems. As of February 1973, 47 procurement specialists within DOD and the services were assigned to this function.

In fiscal year 1972, the PMR groups issued 21 procurement and contract management reports covering 19 regular and 2 special reviews. Regular reviews were based on standard review programs which include a section for the review of the

pricing function, including the essential requirements of Public Law 87-653 and ASPR. The objectives in reviewing the pricing function were to determine whether the procurement organization understands the steps taken to insure good pricing, that it can perform these actions, and that proper practices are followed.

INTERNAL AUDITS

The responsibilities and mission of the internal audit groups in DOD, the services, and DSA are to independently review and evaluate the effectiveness and efficiency with which managerial responsibilities are being carried out. Because they have broad overall mission, the internal audit groups have large staffs--about 3,000 personnel in fiscal year 1973, including administrative and clerical personnel.

In fiscal year 1972, the internal audit organizations issued about 1,130 reports on evaluations of the functions, activities, and operations within their respective departments and agencies. Twenty-one of these reports covered procurement generally, of which 13 included pricing activities.

FOLLOWUP ON RECOMMENDATIONS

To eliminate the recurrence of deficiencies noted in procurement audits, effective followup procedures are needed to evaluate the procurement offices' implementation of recommendations. Of the 39 procurement offices visited, 19 were reviewed by either PMR or internal audit groups or both during fiscal year 1972. The most common deficiencies reported were

- failure to obtain adequate cost or pricing data to support negotiated costs;
- weaknesses in technical evaluations, such as improper techniques used; acceptance of data without verification; and a general lack of documentation to show what was reviewed, how it was reviewed, the results of such reviews, and the rationale for acceptance or rejection of contractors' proposed costs; and

--failure to provide DCAA the results of technical evaluations 5 days before the due date of its audit report.

Other deficiencies, although not occurring as frequently as the above, include the failure to

- prepare adequate negotiation objectives before negotiations with the contractor;
- obtain a properly executed "Certificate of Current Cost or Pricing Data" from the contractor, though required; and
- document adequately the rationale used to construct profit objectives.

Recurring deficiencies noted in fiscal year 1972 and prior years' reports related to inadequate cost or pricing data and technical evaluations and the failure to provide the results of technical evaluations to DCAA promptly. The reports generally contained recommendations for correcting these deficiencies.

The PMR manual for review of contract management states that each DOD PMR component will establish appropriate followup systems but prescribes no method of followup. The Army, Air Force, and DSA PMR groups perform some followup on efforts to implement their recommendations. The Navy PMR group, however, does not followup on its recommendations. The services have procedures for followup on recommendations for corrective action by the internal audit organizations.

These followups, however, have not been fully effective in assisting the procurement offices to eliminate some of the more important recurring deficiencies.

CONCLUSIONS

The reports issued in fiscal year 1972 by the PMR and, to some lesser degree, by the internal audit organizations generally reflected expertise in procurement and pricing. Their reports indicated that the audited sites were basically following the policies and procedures prescribed for pricing noncompetitive contracts; however, the deficiencies noted in

their reports, and confirmed by our findings, show that some weaknesses continue to exist.

The responsibility for taking actions on review recommendations belongs to the procurement activities audited. PMR and internal audit groups should be responsible for making followup reviews and determining the effectiveness of the actions taken. When it is determined that the deficiencies continue to recur despite attempts at correction, these groups should help resolve the problems.

RECOMMENDATION

We recommend that, to effectively resolve important procurement deficiencies in the pricing of noncompetitive contracts, the Secretary of Defense ascertain that PMR and internal audit groups take aggressive followup action to insure that procurement offices are correcting recurring deficiencies.

CHAPTER 7

SUMMARY OF CONCLUSIONS,

RECOMMENDATIONS, AND AGENCY COMMENTS

CONCLUSIONS

DOD's procurement offices are generally doing an effective job in implementing the system established for negotiating noncompetitive contracts. Some improvements, however, are needed in the practices followed by the procurement offices and in management controls to insure the negotiation of fair and reasonable prices.

Elimination of the following major deficiencies will result in greater assurance that contract prices, negotiated without competition, are fair and reasonable.

1. For about 15 percent of the cost examined, there was no record that cost or pricing data had been obtained to the extent required by ASPR. This not only creates doubt as to the reasonableness of contract prices but also may limit the Government's rights to a price reduction under the defective pricing clause. Resolution of this problem basically rests with procurement officials. In most instances, they were not aware that adequate data had not been obtained. (See p. 8.)
2. About 24 percent of the technical evaluation reports examined did not adequately disclose the scope of the evaluation or the analytical methods used or data analyzed or provide sufficient data and rationale to support conclusions and recommendations. In such cases, the contracting officers (1) did not have assurance that prices proposed were fair and reasonable, (2) may have been handicapped in convincing the contractors of the Government's position when costs were questioned, and (3) may have difficulty in later determining what data, if any, the contractor certified to that was submitted informally and relied on during the negotiations. (See p. 11.)

3. Seventy-two of the 173 audit advisory reports contained qualified conclusions because the auditors did not receive the results of the technical evaluation of the contractor's proposal. This affects audit results and indicates that advisory staffs are not exchanging information. (See p. 12.)
4. A number of deficiencies related to the price negotiation memorandum required to be prepared as a record for each pricing action. In 33 instances the contracting officers failed to prepare adequate memorandums; in 53 instances the memorandums contained no statement on the Government's reliance on cost or pricing data submitted during negotiations; and in 23 instances copies of the memorandums were not furnished to DCAA and the ACO, though required. These deficiencies limit the usefulness of the memorandums. (See pp. 13 to 15.)
5. Procurement office reviews are beneficial but have not always identified noncompliance with policies and procedures. These reviews need to be improved so that, when warranted, timely corrective action can be taken. (See p. 19.)
6. Some of the deficiencies in procurement practices or other weaknesses identified by the review groups established by DOD, the services, and DSA may have gone unresolved because of the lack of an aggressive followup on the implementation and effectiveness of recommended solutions. (See p. 22.)

RECOMMENDATIONS

We recommend that the Secretary of Defense:

- Require contracting officers to include in the memorandum of negotiations a statement whether cost or pricing data has been obtained from the contractor in the form and substance required by ASPR and, if not, explain why. (See p. 8.)
- Require activities performing technical evaluations of price proposals to (1) include in their reports the scope of the evaluation, the data analyzed, and the

- data and rationale supporting conclusions and recommendations and (2) coordinate their work to the extent feasible with those performing financial evaluations so that the results can be exchanged promptly. (See p. 12.)
- Emphasize that contracting officers should record in the price negotiation memorandum the principal elements of the negotiation. (See p. 16.)
 - Require contracting officers to state in the price negotiation memorandum whether they did not rely on any data submitted with the proposal and identify any additional data relied on which the contractor submitted thereafter. (See p. 16.)
 - Insure that the price negotiation memorandum is distributed to the ACO and cognizant DCAA auditor so that they may see the results of negotiations and benefit by them. (See p. 16.)
 - Emphasize to procurement offices the importance of their review in insuring that policies and procedures are followed. (See p. 19.)
 - Ascertain that PMR and internal audit groups take aggressive followup action to insure that procurement offices are correcting recurring deficiencies. (See p. 23.)

AGENCY COMMENTS AND OUR EVALUATION

DOD commented on our findings and recommendations by letter dated May 24, 1974. (See app. III.)

DOD said that it subscribes to the basic thrust of our recommendations in that there is always opportunity for improvement in procurement practices and procedures. DOD further said that most of our recommendations would be referred to the military services and DSA as examples of matters of concern in their effort to improve the procurement process within their organizations. DOD also commented that a planned revision of the ASPR Manual for Contract Pricing will contain additional guidance which will improve the pricing of contract awards.

Although we concluded that DOD's procurement offices are generally doing an effective job, we believe that the deficiencies identified are, in themselves, significant, and deserve serious consideration. The referral of these matters to the military services and DSA for individual action might not place sufficient emphasis on the significance of the matters discussed in this report. We believe that our findings and recommendations should be emphasized in the planned revision of the ASPR Manual for Contract Pricing.

DOD does not agree with our recommendation that contracting officers be required to include in the memorandum of negotiations a statement as to whether cost or pricing data has or has not been obtained from the contractor in the form and substance required by ASPR, and if not, explain why a deviation was necessary. DOD is not persuaded that the alleged deficiency is such that adopting this recommendation will prove to be of benefit in the procurement process. DOD contends that judgment plays a large part in what is adequate cost or pricing data and that differences of opinion are likely to arise. In support, DOD states that its evaluation of one of our examples of inadequate data showed that the data obtained was sufficient and in accord with policy requirements. DOD also indicated that disagreement on this one case casts doubt on the validity of our findings that 15 percent of the cost examined was not adequately supported.

We agree that some judgment may be required in determining that a contractor's submission of cost or pricing data adequately and completely describes the basis for its estimates. Criteria set forth in ASPR and the ASPR Manual for Contract Pricing, however, go a long way to minimize the individual judgment needed. In fact, in most cases we concluded that judgment had little to do with the failure by agency officials to identify deficiencies in data submissions. Rather, it appeared no official had assumed the responsibility to determine whether the data submitted was in accordance with established criteria.

DOD indicated that it reached a different conclusion on the one example it commented on because of this judgment factor. In light of this comment, we reevaluated all the data furnished or identified by the contractor or otherwise made available to

the contracting officer in this case. We compared the data available to the contracting officer with that specifically required or indicated as highly desirable by ASPR and the ASPR Manual for Contract Pricing. Our reevaluation supported our original conclusion that the cost or pricing data made available to the contracting officer did not adequately identify the basis for proposed cost. (See pp. 5 to 6.) for a detailed discussion of this case.)

We believe that the difference of opinion here lies not so much in judgment, but in the criteria used to determine adequate submission of data. We believe that DOD relied primarily on the determinations by members of the pricing team that proposed costs appeared to be reasonable. While such determinations are unquestionably a tool which the contracting officer should use in evaluating the reasonableness of contractors' proposals, they are not a substitute for submission by the contractor of required cost or pricing data. The reports of audit and technical personnel which provide advice on the reasonableness of the contractor's proposed costs are not necessarily an authoritative record of the data which the contractor is certifying.

The corrective action we have proposed does not require new direction, but simply places emphasis on an existing responsibility--that of the contracting officer in assuring that contractors submit complete information identifying the basis for proposed costs. Accordingly, we suggest that the Secretary reconsider the position taken on this recommendation.

DOD stated that action has already been taken on our recommendation that contracting officers be required to identify in the negotiation memorandum any data relied on which was submitted informally by the contractor. DOD stated that subsequent to the period of our review, Defense Procurement Circular (DPC) 100 was issued on May 26, 1972; that this circular called attention to ASPR 3-811(a) which requires that the price negotiation memorandum clearly identify submitted data that was not used or was not relied on by the contracting officer in negotiating the contract price.

Based on this response, we believe that our report may not have clearly conveyed the intent of our recommendation. We agree with DOD that existing regulations (emphasized by DPC 100) require contracting officers to identify in the negotiation

memorandum any data submitted by the contractor that was not relied on in establishing a price. We found, however, that a record of the data submitted or identified and certified to by the contractor was not always available. The preparation of such a record is complicated because, as discussed on page 7, data is furnished not only to the contracting officer, in support of the formal proposal, but to other members of the pricing team in response to specific requests for additional information needed to evaluate the reasonableness of proposed costs. It is this supplemental data which may not be well documented or trackable as cost or pricing data submitted for the specific contract action. The following example identified during a recent examination illustrates this problem.

In responding to a solicitation from the Army Rock Island Arsenal for the purchase of 92,000 projectiles, the contractor, on September 6, 1973, proposed costs of \$3.6 million for direct materials and \$1.2 million for direct labor. The technical evaluator told us that the proposal package submitted for evaluation was incomplete. For example, the data submitted by the contractor in support of proposed materials did not identify the basis for the required kinds or quantities of materials or describe how scrap factors and allowances were computed. Discussions with the evaluator indicated that, with the exception of the scrap allowance, the contractor submitted additional supporting data during the technical evaluation. The evaluator, however, did not prepare a record of this data.

Without a complete record of the data submitted and relied on, the Government's rights under the defective pricing clause may be impaired. An example is presented on p. 14. We believe that the price negotiation memorandum should be the focal point for this record. A specific reference to the data submitted and relied on would be necessary only in those instances where no other record of such data is available.

We believe that the benefits to be derived from a complete record of the data provided by the contractor in support of proposed costs included in the negotiated prices would surpass the additional effort needed to provide that record. Accordingly, we suggest that the Secretary reconsider the position taken on this recommendation.

CHAPTER 8

SCOPE OF REVIEW

We directed our review toward determining the extent procurement personnel were implementing policies and procedures in negotiating prices of noncompetitive contracts and the extent that management officials assured themselves that appropriate actions had been taken. We did not evaluate the reasonableness of negotiated prices in relation to cost or pricing information available to the contractor at the time of negotiations. However, we plan to review further some of the procurements where policies and procedures were not adequately followed, to determine whether the prices negotiated were adversely affected.

The 183 actions reviewed were randomly selected from a universe consisting of all noncompetitive fixed-price definitive contracts and modifications exceeding \$100,000 that were negotiated during the last 6 months of fiscal year 1972 on the basis of cost or pricing data. The probability of selection for each action was approximately proportional to the dollar amount involved. This permitted us to concentrate on those actions involving larger amounts. However, since each action was eligible for selection and the selection was random, our findings are representative of the entire universe, not just the actions reviewed.

The 183 actions, valued at about \$2.1 billion (see note p. 1), were awarded by 39 of DOD's approximately 220 procurement offices, including most of the major buying activities. (See app. I.)

We examined records at the procurement offices pertaining to the pricing of the contracts or modifications reviewed. Specifically, we reviewed (1) the cost or pricing data submitted by the contractors, (2) technical evaluation reports, (3) DCAA audit reports, (4) price analysis reports, (5) negotiation records, and (6) records relating to procurement offices' review of the pricing activities. We also discussed our review with those officials who direct and manage the procurement offices. At DOD and service headquarters, we extensively reviewed the recent internal audits of the pricing of noncompetitive contracts.

PROCUREMENT OFFICES VISITED

ARMY:

Missile Command	Redstone Arsenal, Ala.
Corps of Engineers, Huntsville Division	Huntsville, Ala.
SAFEGUARD Systems Command	Huntsville, Ala.
Munitions Command	Joliet, Ill.
Corps of Engineers, Fort Worth District	Fort Worth, Tex.
Tank Automotive Command	Warren, Mich.
White Sands Missile Range, Procurement Directorate	White Sands, N.M.
Aviation Systems Command	St. Louis, Mo.
Corps of Engineers, Kansas City District	Kansas City, Mo.
Corps of Engineers, Buffalo District	Buffalo, N.Y.
Picatinny Arsenal	Dover, N.J.
Frankford Arsenal	Philadelphia, Pa.
Electronics Command	Fort Monmouth, N.J. and Fort George G. Meade, Md.
San Francisco Procurement Agency	San Francisco, Calif.
Edgewood Arsenal	Edgewood Arsenal, Md.
Corps of Engineers, Office of Chief of Engineers	Washington, D.C.

NAVY:

Training Device Center	Orlando, Fla.
Portsmouth Shipyard	Portsmouth, N.H.
Regional Procurement Office	Los Angeles, Calif.
Ship Parts Control Center	Mechanicsburg, Pa.
Aviation Supply Office	Philadelphia, Pa.
Air Development Center	Warminster, Pa.
Air Engineering Center	Philadelphia, Pa.
Ordnance Systems Command	Arlington, Va.
Air Systems Command	Arlington, Va.
Ship Systems Command	Arlington, Va.
Electronic Systems Command	Arlington, Va.

APPENDIX I

AIR FORCE:

Armament Development and Test Center	Eglin Air Force Base, Fla.
Warner Robins Air Materiel Area	Robins Air Force Base, Ga.
Electronic Systems Division	Hanscom Field, Mass.
Aeronautical Systems Division	Wright-Patterson Air Force Base, Ohio
San Antonio Air Materiel Area	Kelly Air Force Base, Tex.
Ogden Air Materiel Area	Hill Air Force Base, Utah
Aerospace Defense Command	Ent Air Force Base, Colo.
Oklahoma City Air Materiel Area	Tinker Air Force Base, Okla.
Space and Missile Systems Organization	El Segundo and Norton Air Force Base, Calif.
Sacramento Air Materiel Area	McClellan Air Force Base, Calif.

DSA:

Defense Construction Supply Center	Columbus, Ohio
Defense Electronics Supply Center	Dayton, Ohio.

PRINCIPAL OFFICIALS OF DOD
RESPONSIBLE FOR ADMINISTERING
ACTIVITIES DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF DEFENSE:		
James R. Schlesinger	July 1973	Present
William P. Clements, Jr. (acting)	May 1973	June 1973
Elliot L. Richardson	Jan. 1973	Apr. 1973
Melvin R. Laird	Jan. 1969	Jan. 1973
SECRETARY OF THE ARMY:		
Howard H. Callaway	May 1973	Present
Robert F. Froehlke	July 1971	Apr. 1973
SECRETARY OF THE NAVY:		
J. William Middendorf II	June 1974	Present
John W. Warner	May 1972	June 1974
John H. Chafee	Jan. 1969	May 1972
SECRETARY OF THE AIR FORCE:		
John L. McLucas	May 1973	Present
Robert C. Seamans, Jr.	Jan. 1969	Apr. 1973
DIRECTOR OF THE DEFENSE SUPPLY AGENCY:		
Lt. Gen. Wallace H. Robinson, Jr.	Aug. 1971	Present
Lt. Gen. Earl C. Hedlund	July 1967	July 1971



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

24 MAY 1974

INSTALLATIONS AND LOGISTICS

Mr. R. W. Gutmann
Director, Procurement and
Systems Acquisition
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Gutmann:

This is in reply to your letter of March 19, 1974 to the Secretary of Defense transmitting for comment a General Accounting Office (GAO) draft report titled, "Some Improvements Needed in Negotiating Prices of Noncompetitive Contracts Over \$100,000 - a Sampling of Fiscal Year 1972 Procurements," (OSD Case #3796).

GAO reviewed 183 noncompetitive procurement actions selected at random from Department of Defense (DOD) business for the first half of FY 1972. The stated purpose of the review was "... evaluation of DOD's performance in negotiating noncompetitive contracts". We are pleased to note that GAO concluded that "... DOD's procurement offices are generally doing an effective job in negotiating noncompetitive contracts ...". However, the report continues and suggests that some improvements are needed in practices followed by procurement offices and in management controls.

The report contains seven recommendations for improvement. In abbreviated form, these recommendations are:

1. Require contracting officers to state that cost or pricing data has or has not been obtained in the form required.
2. Require technical evaluations of price proposals to include more details as to scope and rationale for conclusions.
3. Emphasize that contracting officers record the principal elements of negotiation in the price memorandum.

4. Require contracting officers to identify additional data received or data they did not rely on.
5. Ensure that the price memorandum is distributed to the administrative contracting officer and the defense auditor.
6. Emphasize to procurement offices the importance of precontract review.
7. Ascertain that aggressive follow-up actions are taken by Procurement Management Review and internal audit groups.

We subscribe to the basic thrust of the recommendations in that there is always opportunity for improvement in procurement practices and procedures. In general, the Armed Services Procurement Regulation (ASPR) and the Armed Services Procurement Regulation Manual for Contracting Pricing (ASPM No. 1) provide adequate policy direction concerning the report recommendations. ASPM No. 1 is under current revision and will provide additional guidance which we believe will improve the pricing of contract awards.

Most of the recommendations in the report concern the practices and management controls of DOD components charged with procurement responsibility. These recommendations numbers 2, 3, 5, 6, and 7 identified in the paragraph above will be referred to the Military Services and the Defense Supply Agency as examples of matters of concern in their efforts to improve the procurement process within their organizations. Action on recommendation 4 has already been taken. Subsequent to the period of the GAO review, Defense Procurement Circular Number 100 was issued on 26 May 1972. This circular called attention to ASPR 3-811(a) which requires that the price memorandum clearly identify submitted data that was not used or was not relied on by the contracting officer in negotiating the contract price.

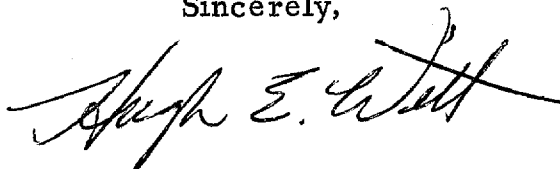
Several of the recommendations pertain to documentation problems. However, recommendation 1 in our view is the most significant in this area. GAO found that in the wide sample of cases reviewed, 85% of the costs examined were adequately supported by cost or pricing data. However, in the other 15% GAO found some inadequacies. Recommendation 1 suggests that if the contracting officer is required to state that the cost

or pricing data has been obtained in the form required by ASPR or explain any deviation, cases of inadequate documentation will be negated. What is adequate documentation in any specific fact situation is principally a matter of judgment. The sense of our ASPR policy and ASPM No. 1 guidance is that cost or pricing data will be obtained from the contractor in sufficient adequacy and completeness to conduct price negotiations, unless the contracting officer has other data upon which the reasonableness of price can be better concluded.

Judgment plays a large part in what is adequate cost or pricing data and differences of opinion are likely to arise. Perhaps this difference of view might be illustrated by reference to one of the cases cited in findings upon which this recommendation is based. The first case cited by GAO concerns an Army award for cartridge cases in which the material cost (steel plate) was indicated as not supported. The contractor in forwarding his price proposal specified the steel plate to be used, its price per pound, the pounds used, and identified the price increases of steel since award of a predecessor contract he was currently performing. Applicable government technical review, price analysis, and audit were performed substantiating the proposal. The defense auditor took no exception to material, noting that the steel price was based on a mill catalog price effective on the same date identified by the contractor as the most recent steel price increase. Negotiations were conducted with all this data available. It would appear to us that the data available was sufficient and in accord with our policy requirements. Other cases cited may be in the same vein. Thus, we are not persuaded at this time that the alleged deficiency is such that adopting this recommendation will prove to be of benefit in the procurement process.

We appreciate the opportunity to comment on your draft report.

Sincerely,

A handwritten signature in black ink, appearing to read "Hugh E. Witt". The signature is fluid and cursive, with a large initial "H" and "W".

Hugh E. Witt
Principal Deputy Assistant Secretary of Defense
(Installations and Logistics)

APPENDIX

TOTAL AMOUNTS DEPOSITED IN AND WITHDRAWN FROM

THE SPECIAL BANK ACCOUNT

JUNE 16, 1971 TO JUNE 30, 1974

	Special bank account	Funds authorized by Public Laws			
		91-441	92-156 (note a)	92-436	93-155
BEGINNING BALANCE		\$200,000,000	\$321,500,000	\$107,600,000	\$28,400,000
DEPOSITS	\$654,028,803				
WITHDRAWALS		^b 200,000,000	^c 321,500,000	^d 107,600,000	^e 24,928,803
Labor	\$142,057,452				
Overhead	199,493,676				
Material and other charges	305,808,750				
Intercompany transactions:					
Charges	\$21,529,644				
Credits	<u>15,058,993</u> <u>6,470,651</u>	<u>653,830,529</u>			
BALANCE AT JUNE 30, 1974		\$ 198,274	\$ -	\$ -	\$ 3,471,197

^aPublic Law 92-156 authorized \$325.1 million; however, Public Law 92-204 appropriated only \$321.5 million which is \$3.6 million less than authorized.

^bInitial payment from this fund was on June 16, 1971, and final payment was on Sept. 6, 1973.

^cInitial payment from this fund was on Dec. 1, 1971, and final payment was on Sept. 6, 1973.

^dInitial payment from this fund was on Mar. 7, 1973, and final payment was on Mar. 13, 1974.

^eInitial payment from this fund was on Mar. 13, 1974.

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