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MAY 19 1976

Vice Adm. K. L. Lee, U.S. Navy
Commander
Naval Air Systems Command
Room 1200, Jefferson Plaza 1
Washington, D.C. 20361

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Dear Admiral Lee:

2 This report summarizes the results of our review of contract N00019-74-C-0131 awarded to Texas Instruments, Inc. (TI), Dallas, Texas, by the Naval Air Systems Command (NAVAIR). We initiated this review subsequent to a nation-wide survey of Department of Defense negotiated prime contracts. Our survey of contract -0131 had indicated possible defective pricing in TI's base shop labor proposal. Base shop labor is a critical cost element since it directly, or indirectly, accounted for \$7,053,971, or about 55 percent of the revised price proposal for this contract. c.511

We found that the negotiated price for contract -0131 was at least \$845,000 in excess of the price indicated by the most current, accurate and complete base shop labor cost data that the contractor had available before contract negotiations. However, the Government contributed to about \$334,000 of this overpricing by overlooking and failing to incorporate in the contract price the lowest base shop labor cost proposed by the contractor. Furthermore, although we did not quantify its effect, we believe the contract price was further overstated because the contractor did not appropriately consider increased future production which could reasonably be expected to impact significantly on proposed contract labor costs.

We also noted other areas relating to the Government's evaluation of the contractor's price proposal that need improving. However, these matters are being reported to the Defense Contract Audit Agency (DCAA) and the Defense Contract Administration Services Office (DCASO) in a separate report. A copy of the report will be submitted to you.

To develop these points, we examined the cost and pricing data submitted by the contractor in support of proposed costs, the negotiation memorandum, selected actual labor costs, and the Government's evaluation of the contractor's pricing proposal.

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We are reporting the contract overpricing point to you for your consideration (1) in improving the applicable procurement procedures, and (2) for determining the extent to which the Government may be entitled to a price adjustment on contract -0131.

BACKGROUND

Contract -0131, awarded to TI on October 1, 1973, was NAVAIR's fourth production buy of AN/APS-116 airborne anti-submarine warfare radar equipment for use on the S-3A aircraft. The firm-fixed-price of \$10,323,000 was negotiated at NAVAIR during the weeks of July 23, August 6 and August 20, 1973. This price included \$7,977,000 for 38 radar systems, spares components and technical data plus \$2,346,000 for an option to buy 12 systems which was exercised on January 16, 1974. The base shop labor contract price per system was \$10,542 for the 38 basic systems and \$10,152 for the 12 option systems. TI's revised contract price proposal which was dated July 24, 1973, amounted to \$12,748,828, including a base shop labor cost of \$9,810 per system. The Certificate of Current Cost or Pricing Data, executed by TI on August 27, 1973, certified that cost or pricing data was current, accurate, and complete as of August 24, 1973, the date of final price agreement.

The contract was negotiated by NAVAIR based on, among other things, DCASO's and DCAA's independent estimates of the price of the planned contract work. DCASO is the cognizant administrative contracting office for the Department of Defense at TI.

OVERPRICING DUE TO DEFECTIVE PRICING DATA AND GOVERNMENT'S OVERSIGHT OF CONTRACTOR'S REVISED PRICE PROPOSAL

TI's revised contract price proposal for base shop labor cost did not include the most current, accurate and complete cost data available before contract -0131 negotiations as required by Armed Services Procurement Regulations (ASPR) 3-807.3 and Public Law 87-653 (10 U.S.C. 2306(f)). Furthermore, the Government overlooked the revised base shop labor cost proposed by the contractor and instead negotiated a higher contract price based on the Government's estimate of labor cost. Consequently, assuming that other pricing factors as negotiated would have remained the same, we estimate that the negotiated contract price was overstated by about \$845,000, including \$511,000 because of defective pricing and \$334,000 because of the Government's oversight in not utilizing the contractor's revised price proposal for base shop labor cost. In addition, TI did not consider future production increases which could have been expected to further reduce the proposed contract price.

Most Current and Complete Cost Data Not Submitted by TI

TI did not incorporate in the base shop labor cost estimate the most current and complete cost data available before contract -0131 negotiations. TI's accounting system provides rolled-up, run cost reports based on labor charges to work orders. Using these run cost reports and estimated equivalent radar systems produced, TI estimated base shop labor costs

based on an improvement or learning curve analysis. Improvement curves graphically portray the relationship between cost and quantity of production units to adjust historical cost for anticipated labor efficiencies due to learning improvement.

To obtain system base shop labor historical costs for contract -0131, TI compiled rolled-up, cost reports one and two (hereinafter referred to as Cost Reports 1 and 2) from selected work order cost data. TI estimated system base shop labor cost for contract -0131 by projecting Cost Report 2 historical cost to planned contract -0131 production units based on the rate of learning improvement experienced between Cost Reports 1 and 2. (See app. I for a more detailed discussion.)

However, the historical cost reflected in TI's Cost Report 2 estimate was not based on the most current cost data available before contract negotiations. Although the revised price proposal was a general update to reflect actual costs to June 30, 1973, base shop labor was based on costs through April 30, 1973, the cut-off date for Cost Report 2. TI officials stated that since Cost Report 2 was manually prepared, an update of shop labor costs to June 30, 1973 could not have been performed during the month before the August 1973 negotiations due to manpower limitations. We found, however, that although the report included over 1,200 line items, a relatively small number of the line items accounted for the bulk of the system costs. More specifically, we selected all line items with a unit cost of \$10 or more and found that 175 line items accounted for about 82 percent of the system base shop labor cost on Cost Report 2. Therefore, we believe that based on such a sample, TI could have obtained a reasonable estimate of base shop labor cost through June 30.

Furthermore, Cost Report 2 was incomplete to the extent that it was based upon only one of several work order production runs. As a result, Cost Report 2 did not include the cost of all parts. For example, based on our sample of the 175 line items, we found that Cost Report 2 excluded cost data for about one-half of the parts actually produced through June 30, 1973. Consequently, since the excluded parts generally had lower costs than the parts included, we estimated that the system base shop labor cost on Cost Report 2 was overstated by about eight percent.

TI agreed that all parts were not covered in Cost Report 2 but contended that the cost of all parts produced under Cost Report 2 work orders was reflected in the revised contract proposal through the use of its improvement curve. However, since TI's improvement curve was determined by using data from the incomplete Cost Report 2, we believe the improvement curve could not have reflected the cost of all parts produced through June 30.

In addition, we found that by June 30, 1973, TI had about eight months of cost experience under work orders for the subsequent Cost

Report 3 which also indicated that shop labor cost was decreasing significantly. For example, we found that by June 30, 1973 the cost of 56 line items under Cost Report 3 had decreased 80 percent from Cost Report 2. The cost of these line items under Cost Report 2 represented 16 percent of the total cost under this report. The total system base shop labor cost of Cost Report 3, which had a November 1973 cut-off date, was about 39 percent lower than system base shop labor cost under TI's Cost Report 2.

Inaccuracies of Data Submitted by TI

We identified two errors in TI's improvement curve analysis, one of which was to TI's advantage and one to its disadvantage. The net effect of the two errors accounted for about \$72,000 of the contractor's share of the overpricing for contract -0131.

The error that was to the contractor's advantage involved an underestimated mid-point of the production systems for the contract. By incorrectly combining contract -0131 quantities with the option units exercised under the preceding contract N00019-72-C-0464, TI computed a mid-point that represents only the third system of about 52 equivalent production systems under contract -0131 (see app. II). The actual mid-point should be about the twenty-sixth unit or one-half of the 52 systems. Therefore, the proposed cost at the TI mid-point is overstated since the cost of the third system will exceed the cost of the twenty-sixth system according to learning improvement theory.

The cognizant TI official could not recall the rationale for TI's mid-point computations. Had the option quantities of contract -0464 been produced concurrently with contract -0131 systems, TI's computation may have been justified. However, we found that the first delivery under contract -0131 occurred about two months after the final delivery scheduled for the contract -0464 option units.

An error in the rate of learning improvement used by TI had the effect of reducing the revised shop labor cost proposed by TI and therefore, represented a disadvantage to the contractor from the standpoint of his proposed cost. TI used a learning improvement rate of 91 percent to project its revised shop labor cost of \$9,810. However, the actual percentage change in cost between Cost Reports 1 and 2, which was TI's stated basis for its improvement curve projection, indicates an improvement rate of nearly 92 percent. Consequently, had TI used the higher rate of learning in its cost projection, the indicated base shop labor cost would have exceeded the \$9,810 labor cost proposed by TI.

The following section develops our estimate of contract -0131 system base shop labor cost based on the most current, complete and accurate cost data available before contract negotiations.

CAO Estimate of Contract -0131 System Base Shop Labor Cost

The contract -0131 proposed price was overstated by about \$511,000 based on our estimate of \$8,814 for system base shop labor as compared

to the revised estimate of \$9,810 which TI submitted to the Government but which the Government failed to consider (see segment below). Our estimate is intended to demonstrate only an approximate cost which could have been projected for contract -0131 had all Cost Report 2 work orders completed by June 30, 1973 been incorporated into the estimate. It should not be construed as a recommended basis for negotiation of a contract price reduction for defective pricing. As explained on pages 6 and 7, the contract -0131 labor cost estimate should also consider the lower costs achievable through increased production quantities and rates to be realized subsequent to Cost Report 2. However, since this would entail assertions regarding the effect on the rate of learning improvement, our estimate is based on Cost Report 2 work orders completed for our sample line items by June 30, 1973. As a result, our \$8,814 estimate is conservative as borne out by actual system base shop labor costs of \$7,647 through 35 percent of contract -0131.

We estimated the contract -0131 system base shop labor cost based on the estimating technique employed by TI. More specifically, we projected our estimate of Cost Report 2 to the mid-point of contract -0131 production units based upon the rate of learning improvement between Cost Report 1 and our estimate of Cost Report 2. (See app. III for a more detailed discussion.)

Our estimating procedure differs from that employed by TI in that we revised cost and number of equivalent production systems under Cost Report 2 based on the most current and complete cost data available before negotiations. We also revised TI's contract -0131 mid-point which we believe was inaccurate as discussed in the preceding segment.

TI's Revised Base Shop Labor
Proposal Overlooked by Government

TI submitted a revised price proposal at the negotiation on July 24, 1973. Although NAVAIR negotiated a sizeable reduction in the total revised shop labor proposed by TI, NAVAIR's negotiation memorandum shows the reduction related primarily to the various labor add-on factors and not to the base shop labor portion of the total proposed shop labor. The NAVAIR negotiator either overlooked or was not advised of the portion of TI's revised proposal relating to system base shop labor cost (i.e., \$9,810 per system which represented a \$2,220 reduction from TI's initial proposal of \$12,030) and negotiated an average system shop labor price of \$10,448 based on DCASO's computed estimate of the per system shop labor cost for the 50 radar systems. Consequently, had the Government simply accepted the \$9,810 proposed by TI and negotiated the same add-on factors, the contract price could have been reduced by about \$334,000.

DCASO personnel told us that they did not evaluate the \$9,810 proposed base shop labor cost per system because the NAVAIR negotiator

did not ask that it be done. Conversely, the negotiator told us that he did request DCASO to review TI's revised proposal, and he did not recall limiting the scope of the review. The request was verbal since time did not permit a written request. Finally, the negotiator told us that he was not aware of TI's lower revised base shop labor proposal. Review of the NAVAIR contract files showed there was no documentation in the files supporting the proposed \$9,810 per system. However, such documentation was available in the DCASO files at TI.

DCAA had only three days to review and comment on the revised price proposal. Officials of the DCAA Resident Office at TI said they simply overlooked the \$9,810 proposal. However, the auditors did analyze the revised base shop labor add-on factors and other cost elements. Also, proposal detail supporting the \$9,810 was included in DCAA's working papers. We recognize, however, that DCAA's initial estimate and recommended base shop labor cost per system was substantially less than the contractor's revised proposal; i.e., \$8,610 compared with \$9,810.

Circumstances of the negotiations may have caused the cognizant Government organizations to overlook the base shop labor revision. The DCASO files contain documentation of dissension between the DCASO price analyst and the NAVAIR negotiator. This occurred in late July 1973 when negotiations were originally convened at NAVAIR headquarters. According to the price analyst, each person thought the other was doing an inadequate job and in the end the price analyst left the negotiations and returned to Dallas, Texas. Before departing, the analyst prepared revised recommendations leaving them and the working papers for the negotiator's use. However, the analyst did not analyze TI's revised base shop labor proposal and recommended an amount that was higher. The July negotiations concluded with no agreements being reached, and when negotiations began again in August, the price analyst did not attend. The negotiator accepted the analyst's entire shop labor recommendation and considered that amount to be negotiated. We believe that the dissension and the analyst's absence from the negotiations precluded the necessary communication and analysis to correct the Government's oversight.

TI's Failure to Consider Future Production

Although we did not quantify the effects, we believe that TI's failure to consider substantial increases in production quantities and rates of production resulted in a significant overstatement of contract -0131 proposed price in addition to the \$845,000 overpricing discussed above.

The definition of cost or pricing data embraces more than historical accounting data. According to ASPR 3-807.3(h), the cost or pricing data also includes, where applicable, such factors as:

"* * *changes in production methods and production or procurement volume, unit cost trends such as those associated with labor efficiency * * * or any other management decisions which could reasonably be expected to have a significant bearing on costs under the proposed contract. In short, cost or pricing data consists of all facts which can reasonably be expected to contribute to sound estimates of future costs as well as the validity of costs already incurred."

Production quantities and rates affect the rate of improvement, and therefore, production cost. The higher the production quantities and rates, the lower the rate of improvement and the lower the unit cost of production. (See app. II.) Furthermore, as production volume increases, unit production cost generally declines due to economies of production.

As stated previously, TI estimated contract -0131 labor costs based upon Cost Reports 1 and 2. These costs represented less than eight equivalent production systems each according to TI. Production part quantities under Cost Report 3, which were available for the follow-on contract N00019-75-C-0133 were more than three times the production part quantities under Cost Report 2. According to one cognizant TI official, the rate of production increased from about one system per month in the initial production lots to about four systems per month in Cost Report 3.

Increased production quantities and rates could have been anticipated by TI well before contract -0131 negotiations based on increased procurement volume. In September 1972, nearly a year before contract -0131 negotiations, the Government procured 42 systems plus spares under modification P00001 to contract -0464, the contract immediately preceding contract -0131. Additionally, in March 1973, the Government requested a quote from TI for 50 systems plus spares subsequently contracted for under contract -0131. Delivery schedules for the above modification P00001 and the request-for-quote required delivery of about four radar systems per month.

We believe the 39 percent decline in actual system base shop labor cost from Cost Report 2 to Cost Report 3 indicates the effect of the substantially increased production volume under Cost Report 3. However, based on information purportedly obtained from TI, the DCASO price analyst attributed this dramatic cost decline to design and manufacturing process changes. TI officials told us that the cost decline was achieved through the combined performance of a large number of dedicated shop, engineering and manufacturing personnel. They further stated that the changes in manufacturing (as referred to above by the price analyst) were incorporated during Cost Reports 1 and 2. Although TI made four major design changes in the radar system

which affected Cost Report 3, TI documentation indicated no cost savings attributable to these changes under the contract.

Contractor Comments

We submitted a statement of our findings to TI for written comment. TI did not provide a written response to our statement; however, TI officials explicitly stated that they disagreed with our conclusions regarding defective pricing. Specifically, TI's position was that (1) the data we reviewed was available to the Government before negotiations, and (2) Public Law 87-653 merely requires disclosure of the most current, accurate and complete cost and pricing data as opposed to incorporation of this data into the price proposal.

According to ASPR 3-807.3(i):

"The requirement for submission of cost or pricing data is met when all accurate cost or pricing data reasonably available * * * to the contractor at the time of agreement on price is submitted, either actually or by specific identification, in writing to the contracting officer or his representative * * *. The mere availability of books, records and other documents for verification purposes does not constitute submission of cost or pricing data."

Although TI provided data supporting the price proposal to the Government for verification, the data was not current, accurate or complete. Further, we found no indication that TI identified in writing to the Government the availability of additional cost data which we found during our review.

CONCLUSIONS AND RECOMMENDATIONS

The contract -0131 negotiated price was substantially overstated because TI based its proposal upon cost and pricing data which were not current, accurate and complete. Furthermore, the Government contributed to the overpricing by failing to evaluate TI's final price proposal in total.

Under the provisions of ASPR 7-104-29(a), contract -0131 was subject to the following Price Reduction for Defective Cost or Pricing Data clause:

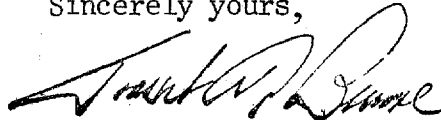
"If any price, including profit or fee, negotiated in connection with this contract or any cost reimbursable under this contract was increased by any significant sums because * * * the contractor furnished cost or pricing data which was not complete, accurate and current as certified in the Contractor's Certificate of Current Cost or Pricing Data * * * the price or cost shall be reduced accordingly and the contract shall be modified in writing as may be necessary to reflect such reduction."

Therefore, we recommend that you (1) determine the extent to which the Government may be entitled to a price adjustment on contract -0131, and (2) consider improving the applicable procurement procedures to insure that the Government's evaluation of proposed pricing data on negotiated contracts includes an analysis of the acceptability of the contractor's incurred and estimated costs. With respect to our first recommendation, consideration should be given to adjusting our estimate of defective pricing for the deficiency which we noted but did not quantify (see page 6). Also, with regard to our first recommendation, we are not advocating recovery of the overpricing that resulted because the Government overlooked the contractor's revised base shop labor cost proposal.

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We are sending copies of this report to the Director, DCAA, and the Deputy Director, Contract Administration Services, Defense Supply Agency. We would appreciate a written reply within 45 days expressing your views and comments on any actions taken or planned on our recommendations.

Sincerely yours,



Forrest R. Browne
Regional Manager

Enclosures:

Appendixes I through III

CONTRACTOR ESTIMATE OF
SYSTEM BASE SHOP LABOR

TI's revised base shop labor cost estimate was \$9,810 for contract -0131 production units as shown by the table below.

Cost report	Fabrication			Assembly			Total cost
	Cost	Equivalent systems	Plot point	Cost	Equivalent systems	Plot point	
1	\$6,329	8	4	\$8,119	4	2	\$14,448
2	5,008	8	12	7,556	6	7	12,564
-0131 estimated cost:			67			67	9,810

TI estimated system base shop labor cost for contract -0131 by projecting Cost Report 2 historical cost to planned contract -0131 production units. To project Cost Report 2 costs to an estimated cost for contract -0131, TI graphically plotted system costs and associated equivalent production systems for Cost Reports 1 and 2. The plot points represent the mid-points of equivalent systems for the two cost reports. TI summed the fabrication and assembly costs at common plot points, and based on the rate of learning improvement experienced between the two cost reports, projected total cost to the 67th production unit. TI proposed the cost of this unit as the system base shop labor cost for contract -0131.

Cost Report 2 figures represent the sum of the average work order costs for each system line item. However, TI used only one of several work order production runs to compute the average work order costs. A TI official contends that since Cost Report 2 was prepared manually, manpower limitations precluded TI from incorporating all work order production runs in the average.

Since Cost Reports 1 and 2 represented varying quantities of parts produced rather than an identifiable number of whole radar systems, TI estimated the number of equivalent production systems represented by each run for fabrication and assembly. Equivalent production systems were subjectively determined by visually scanning Cost Reports 1 and 2 for quantity and cost of individual parts.

COMPUTATION OF THE EFFECT OF TI'S
INACCURATE IMPROVEMENT CURVE ANALYSIS

TI's contract -0131 mid-point computation is shown below.

<u>Contract</u>	<u>Systems</u>
-0442	4.0
-0464 (basic)	<u>13.3</u>
Subtotal	17.3
-0464 (option)	46.8
-0131 (proposed)	52.0

$$\text{Lot mid-point} = 17.3 + \left(\frac{1}{2}(46.8 + 52.0)\right) = 17.3 + 49.4 = 66.7 \text{ or } \underline{\underline{67}}$$

The 67th system represents cumulative production systems through the third system of contract -0131 as follows:

TI mid-point of 66.7 less the 64.1 systems for contracts -0442 and -0464 (i.e., 17.3 + 46.8) equals 2.6 or 3 systems.

GAO's contract -0131 mid-point computation shown below considers the contract -0464 option systems and the contract -0131 systems as separate lots.

$$\text{Lot mid-point} = 17.3 + 46.8 + \frac{1}{2}(52.0) = 64.1 + 26 = 90.1 \text{ or } \underline{\underline{90}}$$

To isolate the effect of TI's inaccurate improvement curve analysis we projected TI's Cost Report 2 estimate to the 90th production unit based on the rate of learning improvement between TI's proposed Cost Reports 1 and 2 as shown by the table below.

<u>Cost Report</u>	<u>Plot point</u>	<u>Cost</u>		<u>92% Improvement slope</u>	
		<u>Amount</u>	<u>Percentage</u>	<u>Factors</u>	<u>Percentage</u>
1	4	\$14,129 ^a	-	.84639999	
2	12	12,318 ^a	87.2%	.74161877	87.6%
-0131 mid-point	90	9,670 ^b	78.5	.58199050	78.5%

^aRepresents Cost Reports 1 and 2 totals after summing fabrication and assembly costs at plot points 4 and 12, respectively.

^bTI computed a system cost of \$9,810 using 67 as the mid-point and a 91 percent improvement slope.

The percentage change between Cost Reports 1 and 2 indicates an improvement slope slightly less than 92 percent even though TI's proposed learning curve shows 91 percent. Therefore, we more correctly projected cost to the 90th unit based on the 92 percent slope. The improvement slope is the rate of learning improvement expressed as the percentage ratio between the cost at any unit and the cost at twice that unit. For example, at a 92 percent improvement slope, the cost of the eighth unit in the table above would be 92 percent of \$14,129, the cost of the fourth unit. However, to determine the cost of the 12th and 90th units, we employed a table of improvement curve factors. The percentage relationship of these factors for the units following the fourth unit represents the percentage relationship of the cost of these units.

The total dollar effect of the \$140 (\$9,810 - \$9,670) overstatement is shown below.

<u>Radar system components</u>	<u>Proposed percent</u>	<u>Overstated base labor</u>	X	<u>Quantity</u>	=	<u>Overstated totals</u>
Power supply	15%	\$ 21		4		\$ 84
Exciter	27	38		1		38
Transmitter	32	45		1		45
Receiver	26	36		5		180
System	<u>100%</u>	<u>\$140</u>		50		<u>7,000</u>
Total overstated base labor						\$ 7,347
Negotiated add-on factors						<u>X 9.7694^c</u>
Overstated negotiated contract price						<u>\$71,776</u>

^cNegotiated add-on factors consist of various elements such as tool maintenance, manufacturing engineering, overhead, general and administrative expense and profit. Therefore, for each dollar change in base shop labor, there is a \$9.7694 change in total contract price.

GAO ESTIMATE OF SYSTEM
BASE SHOP LABOR

Our \$8,814 estimate of contract -0131 system base shop labor costs is shown in the table below.

<u>Cost Report</u>	<u>Equivalent systems</u>	<u>Plot points</u>	<u>Total cost</u>
1	8	4	\$14,129 ^a
2	11	14	11,689
-0131 estimated cost		90	8,814

^aRepresents Cost Report 1 total after summing fabricating and assembly costs at plot point 4.

To obtain this estimate, we projected the \$11,689 shown above to the mid-point of contract -0131 production units (see app. II) based on the rate of learning improvement between Cost Report 1 and our estimate of Cost Report 2.

To derive the \$11,689 Cost Report 2 estimate, we (1) summed the average labor cost for the 175 line items sampled (\$9,394), and (2) added to this total the Cost Report 2 total (\$2,295) derived by TI for the line items not analyzed. The average labor cost of line items sampled included the cost of all work order runs we identified as completed by June 30, 1973 weighted by work order run quantities. We believe our Cost Report 2 estimate is reasonable because our sample included all line items costing \$10 or more and constituted 82 percent of system base shop labor cost under TI's estimate for Cost Report 2.

We computed the 11 equivalent systems for Cost Report 2 by dividing the total work order cost of our sample (\$102,002) by the sample weighted average system cost (\$9,394). The total dollar effect of our system base shop labor estimate compared to TI's revised proposal amounts to about \$511,000 as developed in the table below.

<u>Radar system components</u>	<u>TI proposal</u>	<u>GAO estimate</u>	<u>System excess</u>	<u>X Quantities</u>	<u>= Totals</u>
Power supply	\$1,472	\$1,322	\$150	4	\$ 600
Exciter	2,649	2,380	269	1	269
Transmitter	3,139	2,820	319	1	319
Receiver	2,550	2,292	258	5	1,290
System	\$9,810	\$8,814	= \$996	50	49,800
					\$ 52,278
					X 9,7694
					<u>\$510,725</u>
					Negotiated add-on factors <u>1/</u>
					Overstatement of negotiated price

1/ See note c in appendix II of this report.