DOCUMENT RESUME

06932 - [B2367427]

[Payment of Air Force Aircraft Maintenance Contracts Violate Cost-Plus-a-Percentage-of-Cost Prohibition]. FSAD-78-138; B-169217. August 22, 1978. 4 pp.

Report to Secretary, Department of Defense; by Jerome H. Stolarow, Director, Procurement and Systems Acquisition Div.

Issue Area: Federal Procurement of Goods and Services (1900).
Contact: Procurement and Systems Acquisition Div.
Budget Function: National Defense: Department of Defense - Procurement & Contracts (058).
Organization Concerned: Department of the Air Force; E-Systems, Inc.
Authority: 10 U.S.C. 2306. 38 Comp. Gen. 38. 46 Comp. Gen. 612. 35 Comp. Gen. 533. 22 Comp. Gen. 784. A.S.P.R. 3-807.12.

A recent GAO report about five aircraft maintenance contracts stated that there were violations of prohibitions against a cost-plus-a-percentage-of-cost (CPPC) system of contracting and recommended that excess payments be recovered after determination of what was allowable. The Air Force disagreed with these conclusions and recommendations, stating that rates used for overhead and profit in establishing firm prices were forward-pricing-rate agreements in accordance with regulations and that its pricing method did not violate the CPPC prohibition since it did not involve profit or overhead as a contractually required predetermined percentage. The conclusions and recommendations of the previous report were upheld because: rates for overhead and profit were established prospectively on a percentage basis and the rates remained unchanged; and results of the contract, rather than its technical form, determined violation of the CPPC prohibition. Unless immediate action is taken to eliminate the CPPC system of contracting, exceptions will be taken to payments made to the contractor in excess of allowable amounts. (HTW)

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

B-169217

AUGUST 22, 1978

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

Our report to you (PSAD-78-55 dated January 12, 1978) about five aircraft maintenance contracts stated that "payments to the contractor for certain contractor-furnished materials on two contracts awarded to E-Systems violated the statutory prohibition against a cost-plus-a-percentage-of-cost (CPPC) system of contracting." We further noted that three other contracts also contain similar payment provisions for contractor-furnished materials. Therefore, we recommended that the Secretary of the Air Force determine what is properly allowable under these contracts and to recover any excess payments. Secondly, we recommended that all aircraft maintenance contracts be reviewed so as to eliminate the CPPC system of contracting.

The Department of the Air Force responded to our report on March 27, 1978, and disagreed with our recommendations. The Air Force concluded that the contracts reviewed did not violate the prohibitions against CPPC contracts set forth in 10 U.S.C. 2306(a).

Following is a discussion of the primary points made by the Air Force and our response.

FORWARD PRICING RATE AGREEMENT

The Air Force stated that the rates used for overhead and profit in establishing firm prices for the subcontracted work and contractor-furnished material (CFM) were forward-pricing-rate agreements pursuant to ASPR §3-807.12. The Air Force asserts that all subcontract work and CFM is subject to approval by the contracting officer as to need and quantity, and therefore, the Government has no obligation to accept any work or pay any price not considered necessary and reasonable.

PSAD-78-138
(950307)

The use of forward pricing rates under ASPR §3-807.12 is appropriate where those rates are properly applied in the context of negotiated procurements. However, our examination revealed that both rates for overhead and profit were established prospectively on a percentage basis and the rates remained unchanged. Regardless of whether these rates were established under ASPR §3-807.12, they were treated in such a manner as to become fixed in their application. The fact that these rates were not contractually required does not affect the results of their application under the contracts.

Concerning the provisions that the subcontract work and CFM are subject to approval of the contracting officer, we have consistently held that this provision is not sufficient to save a contract from being construed in violation of the CPPC system of contracting, but is for consideration only in connection with determination of amounts properly allowable as the reasonable value of services or supplies furnished under such unauthorized contracts. 1/

SUBSTANCE OVER FORM IN CONTRACTING

The Air Force also states that its pricing method for the reviewed contracts does not violate the CPPC prohibition for the following reason:

> "As we interpret the cases you cite regarding CPPC contracts, the essential ingredients to establish a CPPC situation is that profit or overhead must function as a contractually required predetermined percentage. That ingredient is missing in the contracts reviewed."

While we agree that some of the cited cases deal with cost-type contracts providing that predetermined overhead rates be applied to some element of direct cost, 2/ the cases are not limited to such instances. In fact, we have decided cases involving situations similar to that under the subject contracts, where the prohibited CPPC arrangements are not provided in the agreements between the Government and its prime contractor, but form the basis of the contractual relationship between the prime and its subcontractors.

1/38 Comp. Gen. 38 (1958); B-175237, November 7, 1977.

2/46 Comp. Gen. 612 (1967); 35 Comp. Gen. 434 (1956).

An example of such a case is 33 Comp. Gen. 533 (1954). In that case, a contractor entered into a cost-reimbursable contract with the Department of the Army during the Korean conflict for installation and rehabilitation of certain equipment and machinery. There existed an understanding between contractor and its subcontractors for payment to those subcontractors of certain undetermined costs to be incurred in the future plus a percentage of such future costs. There was no contractual provision in the prime contract requiring this method of subcontract payment. Vouchers submitted by the contractor, covering the cost of facility and machine tool installations made by the subcontractors, were certified by the contracting officer's representative as being correct and proper for payment. Nonetheless, the Army, in disallowing payment on the vouchers, determined that the cost reflected in the vouchers represented work done on a CPPC basis.

As in our decision 22 Comp. Gen. 784 (1943), we established that the results of a contract, rather than its technical form, is the ingredient essential to the determination of a CPPC violation:

> "'Congress, no doubt anticipating that learned, technical and weird definitions of cost-plus-a-percentage-of-cost contracts would follow a prohibition of a particular species of such contracts, wisely broadened the prohibition to extend to all transactions in which the system was used. What was the 'system' and what was the vice sought to be eliminated? The system was the method of contracting whereby the Government agent's profit or compensation was increased in direct proportion to the cost of the object or commodity itself to the Government. The vice was the temptation, oftentime not resisted, to deliberately or carelessly cause or permit the cost of the object to be increased in order to increase the profit or commission.'" 3/

It is our view that "system" of contracting, as dealt with in those decisions, is broad enough in scope to cover the reimbursement arrangements under the Air Force contracts reviewed.

3/22 Comp. Gen. at 785, quoting from United States v. 94.68 Acres of Land, St. Chas. Co., Mo., 45 F. Supp. 1016, 1019 (E.D. Mo. 1942).

CONCLUSION AND RECOMMENDATION

We remain convinced that the conclusions and recommendations reached in our January 1978 report are sound. Accordingly, unless immediate action is taken to eliminate the CPPC system of contracting, we will be forced to take exceptions to any payments made to E-Systems in excess of the amounts properly allowable under the contracts reviewed. Moreover, similar exceptions will be taken to the other three contracts discussed in our report of January 12, 1978.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Secretary of the Air Force, the Chairmen of the Senate Committees on Appropriations and Governmental Affairs, and Chairmen of the House Committees on Appropriations and Government Operations.

We would appreciate being advised of actions taken on the matters discussed in this letter.

Sincerely yours,

J. H. Stolarow

J. H. Stolarow
Director