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

PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

B-168450

OCTOBER 18, 1979

The Honorable Harold Brown
The Secretary of Defense

Attention: Assistant for Audit Reports
Room 3A336
ASD (Comptroller)

Dear Mr. Secretary:

Subject: Opportunity to Reduce Cost of the Navy's Contract for Patrol Combatant Hydrofoil Missile Ships (PSAD-80-3)

In reviewing the pricing of contract N00024-77-C-2051, we found that the contract price was overstated by about $336,000 because it was based, in part, on the ceiling price for a subcontract rather than the target price. We also found that the Navy will incur excess costs of about $624,000 because the contract requirements were reduced without a corresponding reduction in contract price.

This fixed-price incentive contract was awarded in February 1977 by the Naval Sea Systems Command to the Boeing Company of Seattle, Washington, for the production of five patrol combatant hydrofoil missile ships. We performed this review as part of our review of the pricing of contracts awarded to major DOD contractors. Our objective was to determine the reasonableness of the contract price in relation to cost or pricing data available to the contractor at the time of contract negotiations.

Our review was performed at the contractor's location, where we reviewed documents and discussed them with contractor personnel. We also considered work done by the Defense Contract Audit Agency and the procurement contracting office staff.

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BACKGROUND

Public Law 87-653 requires, with certain exceptions, that prime contractors and their subcontractors submit cost or pricing data in support of proposed prices for noncompetitive contracts expected to exceed $100,000 and certify that the data is accurate, complete, and current. Contract prices can be adjusted when the price to the Government has been increased because the contractor furnished data that was inaccurate, incomplete, or noncurrent as of the effective date of the certificate.

Contract N00024-77-C-2051 was negotiated based on Boeing's February 1977 $181,261,584 cost proposal. The negotiated amounts were as follows:

Target cost	$158,558,000
Target profit	19,442,000
Target price	$178,000,000
Ceiling price	$219,224,000

Under contract incentive provisions, Boeing is entitled to 30 percent of any cost underrun and liable for 15 percent of any cost overruns until total payments equal the ceiling price.

RESULTS OF REVIEW

Target cost overstated because ceiling price used instead of target price

Boeing's proposal included an amount for gearboxes and related parts. The amount included was represented as based on a subcontract competitively awarded to Western Gear. However, the amount actually was based on the ceiling price established for a sole-source, fixed-price, incentive-type contract arrangement similar to the type negotiated between the prime contractor and the Government. In our opinion, if incentive contracts are used for both the prime contract and the subcontract, the prime contract's target cost should include the subcontract target price. Accordingly, the prime contractor's target cost was overstated by the difference between the subcontract target price and ceiling price or by about $336,000. (See computation p. 4.)

Proposed cost included spares not required to be delivered

Boeing's target cost included about $556,000 (see computation p. 4) for a spare gearbox and other gearbox components that Boeing will not be required to deliver to the Navy. However, the target costs (and profit) have not been adjusted even though Boeing will realize substantial cost savings by not delivering the spare items.

Boeing's management plan and related cost proposal were both based on the concept that a spare gearbox would be provided to the Navy. Boeing submitted a "Management Proposal" to the Navy in October 1976 showing that six gearboxes would be required for the prime contract--five gearboxes would be required for production and the sixth was to be used for testing and then refurbished and made available as a spare. The Navy accepted the price Boeing proposed. However, the prime contract did not specifically call for delivery of the spare gearbox or spare parts to the Navy.

After the prime contract was awarded, Boeing deleted the extra gearbox, the spare parts, and the cost of these items from the Western Gear subcontract. At the time of our review, no adjustment had been made to the prime contract target cost and profit as a result of this subcontract modification.

CONCLUSION

In our opinion, the contract target price should be reduced by about $336,000 because Boeing did not disclose that the cost of certain subcontracted items was based on the ceiling price rather than the target price negotiated with the subcontractor. Also, the contracting officer should reduce Boeing's target price by about $624,000 for spare items included in its price proposal that the Navy agreed to because Boeing had indicated they would be made available to the Navy as spares.

Our computations follow:

	Ceiling price vs. target price	Spare items	Total
Subcontract price	$285,375	$529,752	$815,127
Boeing growth factor for anticipated changes in work statement (5 percent)	14,269	26.488	40,757
Boeing target cost	299,644	a/556,240	855,884
Profit (12.26 percent)	36,736	68,195	104,931
Total potential adjustments	$336,380	$624,435	$960,815

a/This amount is made up of $252,896 for the extra gearbox and $303,344 for the spare gears and other spare parts.

AGENCY COMMENTS

Although the procurement contracting officer's representative agreed that Boeing did not inform her of the target price negotiated for the subcontract, she stated that the prime contractor would normally include the target price of any subcontract. However, she added that circumstances might warrant the use of an amount that was either more or less than the subcontract target price. She further stated that facts borne out by later events (the cost of the subcontract will approximate the ceiling price) show that Boeing's decision to use the subcontract's ceiling price instead of its target price was a prudent management decision.

We disagree with the negotiator's position. In our opinion, the use of a subcontractor's ceiling price protects the prime contractor from having to share in cost overruns of its subcontractors and also removes the incentive to manage subcontractors in a manner that will assure that costs are minimized. Therefore, it would not be prudent for the Government to agree to the use of a subcontractor's ceiling price. According to the contracting officer's representative, prime contractors normally include subcontract target prices in their proposals. However, although this practice appears to be reasonable, we could find no DOD guidance on how prices of incentive-type subcontacts should be used in prime contract proposals.

Although the final cost outcome has no impact on whether accurate, current, and complete cost or pricing data was provided by the contractor, our analysis shows that the total amount allocable to Boeing's prime contract target cost for the Western Gear subcontract will be about $1 million less than the price Boeing proposed and the Navy accepted.

The contracting officer's representative agreed that Boeing's target cost includes about $556,000 for spares that Boeing will not be requested to deliver to the Navy, but does not agree that an adjustment of the prime contract price is warranted. She stated that an adjustment is not warranted because the spare items were proposed as needed for testing. However, since the contract was awarded, Boeing has determined that the spares are not needed for testing. This will reduce the contractor's cost and, because of the contracting arrangement, will also reduce the Government's cost.

Although we agree that the contract does not specifically require delivery of the spares, we believe that the Navy should seek an equitable contract price adjustment for spares no longer required to be delivered.

CONTRACTOR COMMENTS

Cognizant Boeing officials agreed with the facts stated in this report.

RECOMMENDATIONS

We recommend that you direct that the contracting officer consider the information presented herein and take appropriate action to adjust the contract targets for (1) the cost overstatement resulting from Boeing's failure to obtain and furnish to the Government accurate, current, and complete cost or pricing data and (2) an equitable credit resulting from the deletion of spare items that the contractor will not be required to deliver to the Navy.

We also recommend that DOD guidance be issued on how incentive-type subcontract prices are to be included in incentive-type prime contracts.

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Copies of this letter are being sent to the President of Boeing Company; the Director, Office of Management and Budget; and the Secretary of the Navy. We are also sending copies to the chairmen of the Senate Committees on Appropriations, Armed Services, and Governmental Affairs and the

House Committees on Appropriations, Armed Services, and Government Operations.

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 would appreciate receiving your comments on these matters and would be pleased to discuss any questions that you may have.

Sincerely yours,

J. H. Stolarow
Director