UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D C 20548

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NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

08 AUG 1983

Vice Admiral E. A. Grinstead, SC, USN
Director, Defense Logistics Agency
Cameron Station
Alexandria, Virginia 22314

Dear Admiral Grinstead:

Subject: Contract Pricing in the Meals-Ready-To-Eat Program (GAO/NSIAD-83-29)

We have examined the pricing of contract DLA 13H-79-C-0979 awarded to Right Away Foods Corporation, Edinburg, Texas, by the Defense Personnel Support Center, Defense Logistics Agency. This contract, priced at $28,431,688, provided for assembly of individual combat meal packages, primarily composed of food component pouches furnished by subcontractors. The contract was the first in a series of contracts awarded to Right Away Foods for assembly of individual combat meals called Meals-Ready-To-Eat (MRE), and was used to establish an industrial mobilization base for the MRE program.

We are bringing our findings to your attention because the contract is one of several contracts in the MRE acquisition program and deficiencies identified are likely to increase total program cost. Details of our review are included in enclosure I and enclosure II lists the contracts under the MRE Program, including the number of cases of food purchased from two suppliers under each contract and the amount paid for each case.

In summary, we believe the Center did not follow sound procurement practices in negotiating this contract. For example:

--The Center awarded a fixed-price contract even though the contractor was a newly formed division with no production history and there was a lack of prior cost experience with the production of this ration.

--The Center deviated from the Government's usual practice by agreeing to directly reimburse the contractor for leasehold improvements to a production facility and did not try to increase competition for this program by telling other possible contractors in the Request for Proposals that it was willing to directly reimburse for investments in facilities.

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--The Center did not follow all of the requirements of the Defense Acquisition Regulation in preparing memorandum records of negotiations in that the memorandums did not adequately demonstrate the reasonableness of the negotiated prices, the appropriateness of demands and concessions made in negotiations, and the extent to which the Government's interests were protected.

--The Center obtained a waiver from following the weighted profit guidelines but the data supporting the basis for the waiver was incomplete and omitted important information pertinent to a determination of the reasonableness of profits.

These poor procurement practices, coupled with audit data that should have been considered, led to acceptance of significant overstated costs, an allowance of greater profit rate than permitted by the weighted guidelines, and direct payment to the contractor for leasehold improvements to an assembly building. In addition, the contract price was inflated because the contractor based a part of its proposed prices on defective cost and pricing data.

Had the Center followed good procurement procedures and carefully considered audit data, about $3.1 million in overstated contract costs might have been avoided, exclusive of profit on any identified defective cost and pricing data. Also, direct payments of $524,000 for leasehold improvements might have been avoided.

Center contracting officials stated that this pricing action finally settled a letter contract for an item with no previous production history and with a contractor with no cost experience. While such conditions would normally not suggest the use of a fixed-price contract, the contracting officer chose to negotiate a fixed-price contract because he wanted the contractor to assume most of the cost risk. To accomplish this, the contracting officer accepted some cost elements that the Defense Contract Audit Agency had advised him were overstated. Contractor officials said they were willing to accept the cost risk of a fixed-price contract because the price was high enough to cover all anticipated costs.

We believe a critical part of the procurement planning for any program is the selection of contract type. When a fixed-price contract is contemplated, adequate cost history and performance data should be available to assure that there are reasonable prospects for negotiating a fair price. Difficulties experienced by the Department of Defense (DOD) in controlling cost reimbursement contracts should not justify the use of overstated fixed-priced contracts.

We recommend that you direct the Center to

--determine the extent to which the Government is entitled to a price adjustment on this contract;

--request that an audit be made to review the pricing of the other MRE program contracts to identify any overpricing and/or defective pricing and obtain appropriate price adjustments where indicated;

--insure that its proposed pricing data evaluation on future MRE contracts includes an analysis of the acceptability of the contractors' estimated costs which should eliminate overpricing and/or defective pricing, such as discussed in this report, or identified through the above recommended review; and

--assure that the contracting officer prepares and maintains accurate and complete records of negotiations as required by the Defense Acquisition Regulation.

The Deputy Secretary of Defense's June 18, 1982, memorandum on use of appropriate contract type emphasizes the importance of selecting the proper contract type and avoiding costly fixed-priced contracts as a substitute for effective program management. This restatement of DOD policy, we believe, provides contracting officers the needed direction in selecting the proper contract type. Accordingly, we are making no recommendations on this subject. However, continuous monitoring and emphasis will be needed to insure that contracting officials are appropriately following the policy guidance.

Although we never received formal DOD comments, we met with Center contracting officials, as well as DOD officials to obtain their views on the matters discussed in this report. Their oral comments are discussed on pages 20 and 21. On March 31, 1983, we received the contractor's comments, which are discussed on pages 22 to 25. Neither the contractor's written comments nor the Center's oral comments provided any new information to convince us to revise the thrust of our report.

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We are sending copies of this report to the Commander, Defense Personnel Support Center; and the Executive Vice President, Right Away Foods Corporation, MRE Division.

Sincerely yours,

Robert M. Gilroy
Senior Associate Director

Enclosures - 2

PROCUREMENT PRACTICES

FOLLOWED IN PRICING

MRE-PROGRAM PRIME CONTRACT

INTRODUCTION

On June 12, 1979, the Defense Personnel Support Center awarded the Right Away Foods Corporation a letter contract to assemble a new combat ration--Meals-Ready-To-Eat (MRE). Under the terms of the letter contract, Right Away was required to deliver 666,720 cases of rations (12 meals a case) at a price to be negotiated. Between June 1979 and January 1981, the contractor and the contracting officer bargained over the contract price, including direct charges for leasehold improvements to the contractor's new assembly building.

The principal contract negotiations were completed in March 1980. Center personnel finally accepted the initial price about 5 months after negotiations had been completed. During this period, the Defense Contract Audit Agency (DCAA) audited the prime contractor's revised overhead costs and reported several cost changes. These cost changes were not considered sufficient by the contracting officer to warrant reopening negotiations.

Right Away Foods is a wholly-owned subsidiary of Right Away Industries, Inc. The operations of Right Away Foods are conducted by two divisions--Freeze Dry and MRE. The MRE Division was organized solely to respond to the Government request for proposal, and at the time of its offer, it had no assembly facilities or prior production history.

In fact, after considering the MRE Division's first offer, the Center's preaward survey team recommended no award be made because the Division, among other things, had no production or assembly facilities. This decision was reversed and contract award was recommended, although most of the conditions cited in the preaward survey had not changed. The only change cited was improved financial capability created by a joint venture agreement.

Right Away Foods was one of three contractors awarded a prime contract for the 2 million case production test of the new combat meals. In November 1980, one contractor was terminated for default, and the quantity terminated was reprocured from the remaining two prime contractors--Right Away Foods and Southern Packaging and Storage, Incorporated. Follow-on assembly contracts for 4 million cases were awarded after the initial production test. As of June 1982, both prime contractors had received letter contracts for an additional 1.15 million cases each.

Since Right Away Foods and Southern Packaging now provide the "industrial mobilization base" (the capacity to produce under national emergency conditions) for the new combat meals, the Center has been dividing requirements between them. Pricing of the sole source awards has been by negotiation, except for one competition between the two suppliers. (See enc. II for the contracted quantities and the price per case for both contractors.)

Although our work focused on the price negotiations with Right Away Foods, we observed that shortcomings in the overall program reported by the Defense Audit Service were contributing factors in the contract pricing problems we identified. In May 1981, the Defense Audit Service reported that the program's procurement plan had been developed and that the production contracts had been awarded before full development and production testing was completed. The report expressed concern about several issues, including the following:

--The new ration required a new production technology not available from a large industrial base.

--Unlike the prior combat rations program, in which the Government contracted separately for food components and delivered the components to an assembly contractor as Government-furnished material, the new program requires the prime assembly contractors to obtain most food components.

--The procurement plan would reduce competition.

The lack of an industrial base for assembly of the new rations and uncertainty about continued production were apparently the primary reasons the contracting officer agreed to pay for Right Away's leasehold improvements. The extensive use of subcontractors in the initial contract was driven by the decision to have the assembly contractors, rather than the Government, acquire the packaged food components. This resulted in the two contractors buying the same packaged food components using the same Government purchasing description and sometimes buying from the same subcontractors. Duplication of subcontractors rather than expansion of the industrial base was probably inevitable, and duplication in costs should have been expected.

SCOPE, OBJECTIVE, AND METHODOLOGY

This review was part of our overall effort to monitor the Center's adherence to prescribed laws, regulations, and procedures in negotiating contracts. Our objective was to assess the Center's effectiveness in negotiating fair and reasonable contract prices based on cost or pricing data available at the time of negotiations.

We selected contract DLA 13H-79-C-0979, to review because (1) it appeared to be overpriced based on our initial survey and (2) it was the first in a series of contracts and any pricing deficiencies in the initial contract could be embodied in follow-on contracts.

Under the provisions of the Defense Acquisition Regulation (DAR) 7-104.29(a), this contract 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. * * *"

We obtained the contractor's reported actual contract costs and evaluated its certified cost or pricing data. We also reviewed the cost analyses and the technical evaluations the contracting officer or members of his team made for adequacy and timing in relation to negotiations. We discussed our objective, as well as data and information obtained, with contractor personnel and with the contracting officer and/or members of his team, including the Defense Contract Administration Services Office and DCAA. We also obtained a written response from the Commander of the Defense Personnel Support Center concerning direct payment for leasehold improvements. Our review was made in accordance with generally accepted government auditing standards.

Our work was performed at Right Away Foods Corporation, Edinburg and McAllen, Texas; Sterling Bakery (one of Right Away's suppliers), San Antonio, Texas; Defense Personnel Support Center, Philadelphia, Pennsylvania; Defense Contract Administration Services Management Area and DCAA, San Antonio, Texas; and Defense Contract Administration Services Region, Dallas, Texas.

INITIAL CONTRACT PRICING

In negotiating this contract, the contracting officer chose to use a fixed-price contract even though the contractor was a newly formed division with no production history and there was no prior cost experience with production of this ration. To reach a fixed price agreement in these circumstances, the Center's contracting officials accepted several uncertain costs and an unjustified profit which overstated the contract price. We believe the Center did not follow sound procurement practices and the contractor provided cost data that was not accurate, current,

and complete. We also believe the contract was overstated by about $3.1 million and an additional $524,000 was paid directly to the contractor for leasehold improvements to a production facility as shown in the following table.

Leasehold improvements		$524,000
Overstated contract items:		
Lease costs		$325,000
Subcontract costs		392,000
Profit on interdivisional transfer		379,640
Overhead and other direct costs:		
Fringe benefits	$108,366	
Equipment rental/ depreciation	248,010	
Travel	73,400	
Component destruction	unknown	
Severence pay	170,960	
Facilities capital	71,616	672,352
Profit considerations		1,320,000
Total overstated contract items		$3,088,992

In addition, the costly building lease expenses are being carried forward into follow-on contracts.

The memorandum records of negotiations prepared on this pricing action did not meet all the requirements of DAR. The DAR requires contracting officers to prepare a memorandum at the end of each negotiation, setting forth the principal cost elements and rationale for their accceptance.

These memorandums should demonstrate the reasonableness of the negotiated prices, the appropriateness of demands and concessions made in negotiations, and the extent to which the Government's interests were protected. Therefore, the memorandum should explain why cost or pricing data was not required. For example, if a negotiated contract is over $500,000 (formerly $100,000) and cost or pricing data was not used, the method of determining the price should be stated in the memorandum. In addition, the memorandum should reflect the extent the cost or pricing data was not used by the contracting officer in determining the total price objective and in negotiating the final price. The determination of the profit objective is also to be fully documented in the memorandum. As the following sections show, these requirements were not complied with.

Leased production facility

The Center restricted competition when, without public notice, it deviated from the Government's usual requirement that the contractor furnish all facilities needed to perform contracts. Also, the $650,000 annual lease cost for the facility was overstated by $325,000.

Right Away Foods' contract performance depended on the timely construction of an assembly building. The contractor, therefore, agreed to enter into a lease agreement for an assembly facility to be constructed by a specified date. After award of the letter contract, but before construction began, Right Away Foods requested that the construction cost for certain leasehold improvements be directly reimbursed by the Center. The leasehold improvements included offices, restrooms, air-conditioning, fire sprinklers, paved parking lot, truck ramps, and several minor items. The contracting officer agreed and the contractor was paid about $524,000 for these items, or 24 percent of the building's estimated construction cost.

Normally, contractors furnish all facilities needed to perform Government contracts. When improvements to leasehold facilities are needed to perform contracts, the normal treatment is for the contractor to capitalize the costs of improvements and depreciate the improvements over their useful life. The depreciation expense is charged to the benefiting contracts.

Since the new rations required a new production technology that was not available from a large industrial base, it was likely that contract performance would require new production facilities. Those in charge of the MRE program should have realized this in advance. In the request for proposals they should have expressed a willingness to deviate from normal practices.

Public notice of the Government's willingness to directly reimburse for investments in facilities, we believe, could have increased competition for this program. The need for increased competition was cited in the Defense Audit Service report. The Defense auditors noted that major food processors did not respond to the request for proposals because of the technical risk and anticipated large fund investment in production capacity.

In addition to the direct payment of leasehold improvements, the Center accepted a monthly lease cost of 40 cents a square foot, which did not include most building ownership costs. Ownership costs are separate charges and include such items as liability and hazard insurance, city and county property taxes, and interior building maintenance. In direct charges of $524,000 and lease payments of $650,000 alone, the Center accepted, as initial contract cost, about $1,174,000 for the contractor's 1-year occupancy of the leased assembly building. This amount was over one-half the lessor's estimated construction cost of

$2,200,000. Under the 1-year lease, renewable annually for 10 years, the lease cost chargeable to follow-on contracts will be about $650,000 annually, excluding the above ownership charges.

The lease cost of 40 cents a square foot was established by a lease agreement signed in October 1979. The Center accepted the contractor's actual lease cost as reasonable based on a DCAA review of comparable lease data furnished by the contractor. However, we found that the comparable data supporting the reasonableness of the lease cost was defective and that DCAA did not question the reasonableness of the data.

Our review shows that the contractor had submitted rental data for five buildings, four of which were manufacturing facilities and not comparable to the MRE facility because the latter was constructed as a large warehouse. This warehouse was converted to an assembly facility through an expenditure of $524,000 for leasehold improvements charged directly to the contract. We believe a more equitable comparison would have involved obtaining the lease costs of similar sized warehouses and comparing the data to the MRE facility, excluding the cost of improvements.

Our review also shows that three of the five buildings were located in the McAllen Foreign-Trade Zone where property commands a premium price because of tax and other advantages. Yet, not one of these three, or the other two facilities used by the contractor, had leased costs as high as 40 cents a square foot or were as large as the 135,000 square foot MRE warehouse.

A local commercial real estate agent informed us that warehouse space in McAllen, Texas, had leased from 12 to 25 cents a square foot in 1979 and 1980. He also said that warehouse space over 40,000 square feet was leased for about 10 to 20 cents a square foot. In 1981 the MRE Division leased 50,000 square feet of new warehouse space nearby for 20 cents a square foot--one-half the MRE assembly building lease rate. At 20 cents a square foot, the cost to lease the assembly building would have been $325,000 annually, rather than $650,000.

Subcontracts

Right Away's contract was 62 percent subcontracted. The three major subcontractors, that packaged the thermostablized food components, were Sterling Bakery, Fresh Flavor Meals, and Hormel Company. We reviewed audit reports and price negotiation records for these subcontractors and for an interdivisional transfer from Right Away Foods, Freeze Dry Division. We also reviewed cost and pricing data used in pricing the Sterling subcontract because Sterling was also a subcontractor to another prime contractor.

In reviewing negotiation records, we noted (1) duplicate or unreasonable costs on the Sterling Bakery subcontract, (2) an unexplained increase in the Fresh Flavor Meals subcontract, and

(3) a profit on the interdivisional transfer from the Freeze Dry Division. As a result, we believe costs were overstated by $392,000--$150,000 pertained to the duplicate costs and $242,000 pertained to the unexplained increase. We also believe the profit on the interdivisional transfer was unacceptable and resulted in additional costs totaling $379,649. These items are discussed in the following sections.

Duplicate or unreasonable costs

Right Away's agreement with Sterling Bakery, a supplier of cakes and cookies, was negotiated at a dollar amount equal to a Sterling subcontract for an equal quantity of the same products with Southern Packaging, the other prime contractor. While the Center's contracting officials tried to avoid duplicate costs by adjusting the overhead rates during negotiations, duplication of several costs occurred between the Right Away subcontract and the Southern Packaging subcontract. The duplication was reported to the contracting officer by DCAA in eight separate audit reports on eight bakery products.

Although we did not determine the total amount of duplicate or unreasonable costs on Right Away's subcontract with Sterling, we did identify $97,000 in duplicate costs and $53,000 in unreasonable charges. For example, direct labor and material start-up costs of about $87,000 were included in Southern Packaging's negotiated price with Sterling and also in Right Away's agreement with Sterling.

The element "other costs" in Sterling's estimate also includes duplicate and unreasonable costs. For instance, over $10,000 in costs was included in both the Sterling and the Southern Packaging subcontracts for Department of Agriculture inspections and for leasing of equipment.

Right Away was paid the same amount in freight charges with its subcontractor, Sterling Bakery, that Southern Packaging was paid on another subcontract with Sterling for freight charges. We believe these freight charges to Right Away would appear to be unreasonable because the distance between Right Away Foods and Sterling is about 240 miles, while the distance between Southern Packaging and Sterling is about 1,300 miles. We noted that DCAA had notified the contracting officer about this matter and cited there was $53,000 of excess freight charges in Right Away Food's subcontract. However, the contracting officer failed to delete this amount from the contract.

Regarding duplicate costs, the contracting officer, in an addendum to the price negotiation memorandum, acknowledged that some duplicate cost occurred, but justified it as acceptable based on speculation about possible cost increases that had not been considered. This, in our opinion, did not justify accepting costs that had been reported by DCAA as being excessive.

Unexplained increase on subcontract

Fresh Flavor Meals, a subcontractor providing packaged entrees, would not consider a subcontract price below its proposal of $6,382,000. DCAA audited the $6.38 million proposal and questioned about $1.88 million, primarily in manufacturing overhead costs. Most of these overhead costs involved the subcontractor's proposal to charge the total acquisition cost of production equipment and building improvements, an estimated $1.13 million, to the initial subcontract. The auditors identified about $830,000 as unsupported acquisition and depreciation costs on production equipment and building improvements.

Unable to resolve the cost differences, the contracting officer, acting for the prime contractor, compared the proposed price to other subcontract prices for the same food items and arrived at a high objective cost of $4,583,000, which included a proposed profit of 12.5 percent. Right Away Foods refused this offer and finally settled on a subcontract price of $4,825,000. This provided a profit factor of about 18.4 percent on supported subcontract costs.

The price negotiation memorandum did not adequately justify the Center's acceptance of a subcontract price that was about $242,000 more than the contracting officer's high objective price. The contracting officer cited Fresh Flavor's small size and disadvantaged status as justification for exceeding the proposed profit objective. However, this justification was irrelevant since the subcontract was not being priced under small business procedures. The contracting officer also cited a DAR provision concerning possible actions when cost and pricing data is not available as further justification. This too is irrelevant since the available cost and pricing data did not support the contract price. Moreover, the contracting officer's comparison of other subcontractors' unit prices with Fresh Flavor's unit prices did not support the additional $242,000.

Profit on interdivisional transfer

The Freeze Dry Division was selected to supply food components to the newly formed MRE Division. The negotiated amount of the interdivisional transfer was $2,910,572, which included a 15-percent profit of $379,640. DCAA questioned interdivisional profit, citing DAR 15-205.22(e), which prohibits profits on such transfers and prevents a firm from pyramiding profits on subcontracts awarded to itself unless it meets one of the approved exceptions.

According to the negotiation memorandum, the contracting officer accepted the profit because he believed the price was based on adequate competition, which is an exception to the pyramiding rule. Later, after the March 1980 negotiation, the contracting officer requested the contractor to provide documentation to support adequate competition. However, the

memorandum of negotiations stated that such documentation was not available. Although the interdivisional profit could not be justified, the contracting officer decided not to reopen negotiations. The reasons for not doing this are discussed in the following section. Acceptance of pyramided profits, we believe, was based on inaccurate contractor data.

Overhead and other direct costs for Right Away Foods

We believe that overpricing occurred in six overhead cost elements consisting of (1) fringe benefits of $108,366, (2) equipment rental/depreciation of $248,010, (3) travel of $73,400, (4) component destruction of an unknown dollar amount, (5) severance pay of $170,960, and (6) facilities capital of $71,616.

Several line items within the overhead and other direct cost elements were negotiated at amounts not supported by the available cost and pricing data. The original proposal for these elements was for $5,049,137. Of this amount, DCAA auditors questioned about $1.6 million and determined that another $1.2 million was not supported by cost and pricing data. Then, before negotiations were started, the contractor submitted a revised proposal of $8,129,681. Most of the increase was not supportable. We believe it was proposed as a negotiation strategy to hasten agreement on the contract price.

After the March 1980 negotiations, the contracting officer requested DCAA to review the prime contractor's cost and pricing data for overhead cost estimates submitted during negotiations. The auditors reported their audit results in August 1980, but did not place a dollar value on the questionable costs identified because they believed the contract price had been established in the March 1980 negotiations.

The Center's need for a dollar effect to use in reconsideration of the March 1980 price and the possible option of reopening negotiations was not clearly communicated by the contracting officer to DCAA. The contracting officer, without a dollar effect of the questioned overhead costs, chose not to reopen negotiations because he was concerned that the contractor would seek additional increases for other contract items. Overhead and other direct costs were ultimately negotiated at $5,080,987, about $32,000 more than the original proposal.

An explanation of each of the overhead cost elements follows.

Fringe benefit rates

The contractor initially proposed a fringe benefit rate of 17.89 percent on total salaries and wages. The fringe benefit rate is made up of a number of individual rates for various

fringe benefit elements, such as State unemployment and workman's compensation insurance. DCAA's audit confirmed the rates' reasonableness on the basis that the rates represented actual corporate experience. However, in preparing for contract negotiations, the contracting officer raised the rate to 21.88 percent for salaries and to 23.25 percent for wages. In the prenegotiation memorandum, the contracting officer stated that an error had been made in the application of the individual rates for FICA and State unemployment insurance rates, but did not explain the nature of the error. The negotiation memorandum similarly cited the new fringe benefit rates without further explanation.

DCAA's audit of the new rates used during negotiations disclosed that the rates were inappropriate for several reasons. First, they included payroll tax and insurance rates that should have been applied to various maximum taxable amounts per employee per calendar year instead of total gross salaries and wages. Second, the rates were based on a workman's compensation rate of 5.15 percent instead of a rate that had been adjusted to reflect the lower corporate experience rate. Third, the contractor had obtained a State employment rate of 0.1 percent by association with the Freeze Dry Division instead of the 2.7 percent allowed by the contracting officer.

The fringe benefits were negotiated at $517,748 using the data developed by the contracting officer. Using the 17.89 percent rate initially audited would have supported $409,382, or about $108,366 less than was actually negotiated.

Equipment rental/depreciation

This cost element, estimated at $180,000, was not supported by the contractor's initial proposal. Subsequently, during negotiations, the contractor provided cost and pricing data to support $535,192, which was the final figure negotiated. Of this amount, $73,798 applied to the planned rental of equipment and $461,394, involved sales taxes, freight costs, and depreciation on expected production equipment purchases. The equipment to be purchased, totaling $874,579, was listed in the price negotiation memorandum.

During the subsequent audit of overhead costs, DCAA reported that a local bank, not the contractor, had purchased the production equipment for about $542,000 and negotiated a rental agreement with the contractor for 36 months at $17,782 per month for the equipment. The total cost to rent the added equipment would have been $213,834. Thus, the $461,394 negotiated for sales taxes, freight, and depreciation of planned equipment purchases was $248,010 more than the equipment rental expense.

In an addendum to the price negotiation memorandum, the contracting officer stated that the cost under either arrangement would have been substantially the same as the following table shows:

		Lease arrangement
Lease cost for 1 year		$213,384
Planned equipment purchases	$874,979	
Equipment purchased by bank	542,000	
Difference	$332,979	
Depreciation on difference		221,986
Total		$435,370
Comparable amount negotiated		$461,394

The contracting officer assumed that the contractor had purchased $332,979 in equipment, which is the difference between the contractor's planned purchase and the bank's purchase. The contracting officer also assumed that the $332,979 in equipment was depreciated on an accelerated basis. However, the contract files did not support the contracting officer's rationale nor did he provide us with any additional evidence to support his belief that the contractor purchased this equipment. A detailed analysis of the dollar effects of changing from an equipment purchasing arrangement to an equipment leasing arrangement should have been made before the contracting officer negotiated the price.

Travel

In reviewing the contractor's proposed travel cost, DCAA considered the proposed number of trips excessive, but was not provided data on the nature of the trips or the employees involved. DCAA questioned about $30,000 of the travel cost because of excessive daily expense rates.

In negotiating the $190,000 travel cost, the contracting officer believed more travel would be performed than was planned. His belief was based on data provided by the contractor during negotiations. The contracting officer accepted costs which covered 130 trips to subcontractors and 29 trips to the Philadelphia contracting office during an 18-month period. He also accepted about $73,400 for monthly travel expenses for five employees that he assumed were associated with the joint venture and with the contract.

In the subsequent audit of overhead costs, DCAA pointed out that the data provided during negotiations was a projection of a non-typical month and the travel of five employees not associated with the contract. The purpose of the travel, DCAA noted, was not clear nor was it clear if DOD would receive any benefit from this $73,400 expense.

The contracting officer's memorandum of negotiations did not discuss the propriety of the travel for these five employees.

Component destruction and loss

We noted there was a wide difference between the contractor and contracting officer as to what an adequate allowance for component destruction and loss should be and what it should cover. The memorandum of negotiations did not reconcile this difference or adequately explain the reasonableness of the negotiated amount. Therefore, our efforts were hindered in reconstructing the contracting officer's basis for concluding that this allowance was fair and reasonable.

The contractor originally proposed a factor of 0.5 percent to be applied to contractor-furnished material, or $99,115 to cover losses for component destruction during performance of the contract. The contracting officer's negotiation objective for this line item was $81,264.

During negotiations, the contractor increased his initial proposal to $875,000 to cover losses from employee theft and pilferage and spoilage in packaging food components purchased under subcontracts or obtained from the interdivisional transfer. The contracting officer's negotiation memorandum stated that a reasonable loss percentage for food components would be 2.25 percent, or $412,546. The memorandum did not show how this rate was developed and what it was to cover.

In the subsequent audit of overhead costs, DCAA stated a technical evaluation was needed of the 2.25 percent rate. However, the records do not show that the contracting officer requested a technical evaluation be made. This evaluation would have shown how this rate was developed and what it was intended to cover, which we believe was critical to assure that the rate was fair and reasonable. If the losses were for theft and pilferage, there would be no residual salvage value to consider. If the losses were from damaging food components during packaging, there would be a question of residual or salvage value. Finally, if damage to food components were expected to occur during processing, there would be a question of whether the loss had already been anticipated in the subcontracts. In the absence of a technical evaluation, we could not address the cost implications of these issues in assessing the reasonableness of the price.

The addendum to the negotiation memorandum stated that the 2.25 percent rate was acceptable because another contractor that had been awarded a contract for MRE had a 3-percent rate. Again, the memorandum did not explain the composition of the 3-percent rate or the basis for considering it to be comparable.

The contractor's records show that the total food component losses were $58,046, or $354,500 less than the $412,546 negotiated.

Severance pay

An amount for severance pay was added during negotiations. The price negotiation memorandum stated the contractor had a contractual agreement requiring severance pay to employees. Consequently, the contracting officer accepted $170,960 as reasonable.

In the subsequent audit of overhead costs, DCAA questioned the proposed severance pay allowance because it was a contingency involving termination of operations and should have been excluded from the cost estimates. This is in accordance with DAR 15-205.7 (c)(ii), which does not provide for this contingency. However, the contracting officer never addressed this DAR provision in the memorandum of negotiations.

The contractor recorded no payment of severance pay even though operations were stopped after contract completion. When we requested a copy of the contractual agreement for severance pay, a contractor official stated that no such agreement existed. The acceptance of this cost by the contracting officer was apparently based solely on the contractor's assurances during negotiations that a contractual agreement existed.

Facilities capital

The contractor's initial proposal did not contain an amount for capital cost. However, the contractor's revised proposal showed the cost of money would be $56,017 for capital equipment investment. During negotiations, the contracting officer accepted $71,616 as the cost of money for the proposed investment in capital equipment.

In its later audit of overhead costs, DCAA reported that (1) the cost of money had been computed incorrectly and (2) the contractor did not actually buy the equipment upon which the computation of cost of facilities capital was based. DAR (Appendix O, Cost Accounting Standard 414) requires an actual measurable capital investment in facilities. In the absence of a capital equipment investment, the cost of money would not be allowable.

In the addendum to the negotiation memorandum, the contracting officer stated that $71,616 was acceptable because the contractor had planned to make a capital investment during the March 1980 negotiations. However, since the contractor did not make a capital investment, the contracting officer should have followed DAR and reopened negotiations to eliminate this $71,616 cost.

Profit considerations

The pricing of this contract on a fixed-price basis was intended to shift most of the cost and technical risk of performance to the contractor and to reward the contractor for accepting those risks by increased profits. Our evaluation of the negotiation disclosed that the conditions necessary to accomplish the pricing objective--reasonable cost estimates and clearly defined risks--were not present.

The final profit negotiated was $3,699,254 million, or about 15 percent of the negotiated $24,733,134 contract cost. The Center's initial price objectives, costs, and profits, as stated in the prenegotiation memorandum, are shown in the following table:

Objective	Price Cost	Price Profit	Total
	------ (millions)	-----	
Low	$17.9	$2.5	$20.4
Target	20.3	3.0	23.3
High	24.3	3.6	27.9

These price objectives were developed from audited cost and pricing data and were approved by Center officials before negotiation. However, during negotiations, the contractor increased its proposal from $31.2 million to $36.8 million, which included substantial increases in overhead costs. This increase, according to the Defense Procurement Manual for the Guidance of Contracting Officers, should have placed the contracting officer on notice that the contractor may have been reluctant to assume cost risk. This manual provides that when a contractor's estimate is 20 percent greater than reliable Government estimates, there may be a presumption of contractor cost risk avoidance. In this instance, the contractor's estimate of $36.8 million was 31 percent higher than the Government's high objective of $27.9 million and 58 percent higher than the target objective of $23.3 million.

At this point, the contracting officer should have obtained a technical analysis and an audit of the contractor's $36.8 million proposal. Instead, the contracting officer chose to enter into a fixed-priced contract and increase the profit objective for the contractor's assumed cost risk above that permitted under the weighted guidelines. Yet, the manual states

that when higher costs are negotiated on fixed-price contracts, the lower the contractor's risk and, therefore, the lower the profit warranted to the contractor within the appropriate weighted guidelines percentage range. In this case, the contracting officer established a profit objective of 10 percent for cost risk, whereas the guidelines would have indicated a range of 6 to 8 percent.

Since the total profit objective exceeded the maximum amount permitted under the weighted profit guidelines, the contracting officer obtained a waiver in accordance with the requirements of DAR 3-808. The waiver permitted the contracting officer to increase the percentage profit for cost risk and to provide a special profit percentage.

Our review shows that the findings to support the waiver were incomplete and that the waiver omitted important information pertinent to a determination of the reasonableness of profits by reviewing officials. The waiver indicated that the specifications involved the newest technology available to the food industry for mass production of combat rations. The waiver did not disclose that a Government purchase description, rather than a specification, was to be followed in performing the contract and that the requirements for following the purchase description would be waived until the subcontractors could develop satisfactory production specifications. In addition, the waiver did not disclose that the subcontractors, not the prime contractor, had most of the risk of applying new technology for mass production of combat rations.

The waiver indicated that because retortable pouch technology (capability to heat food in pouches) was still in the early stages, the current contracts required substantial investments in capital equipment that would soon become obsolete. It did not disclose, however, that only the subcontractors invested in retortable equipment. Consequently, the prime contractor had no expense or exposure to risk of obsolescence pertaining to the retort equipment investment.

The waiver stated that the flexible packaging required is composed of aluminum and polyethelene, both of which are highly volatile market items. It also stated that the letter contract required a substantial monetary investment on the part of the prime contractor before definitization of the contract and that this involved a cost risk for the prime contractor. The waiver did not disclose that the flexible packaging cost on the prime contract was less than 1 percent of the contract price, nor did the waiver state that the prime contractor would not be exposed to any cost growth on flexible packaging that was used by the subcontractor. The waiver similarly did not disclose that the monetary investment required by the prime contractor was minimal because progress payments during the letter contract phase were provided to the contractor, as well as $524,000 of direct payments for leasehold improvements. Also, the waiver did not

discuss the fact that there is a presumption that costs the contractor incurs in performing a letter contract are considered reasonable and reimburseable unless the Government can show the costs should not have been paid or were not allowable or allocable to the contract.

. The waiver stated that contracts for the previous ration--Meal, Combat Individual (MCI)--normally were awarded after formal advertising and that a recent MCI contract was awarded using an estimated profit rate of 14.5 percent. Based on that rate, the waiver stated that a higher profit may be justified for the MRE contracts.

The waiver did not disclose that the MCI assembly contractors were provided most food components as Government-furnished material. Consequently, the MCI assembly contracts did not have a high dollar level of subcontracts upon which to compute profit. In the MRE contract, subcontract efforts amounted to $15,424,786, or 62 percent of the $24,733,134 total contract cost, thus providing the contractor the opportunity to earn more profit even if the profit rate was not increased.

The profit justification indicated there was a high degree of cost risk in producing the items as required and identified one of the risks as a high rate of rejection and rework due to stringent Government inspection. For this reason and because of "extreme difficulty in managing subcontracts for the retort pouch items", a high weight of 10 percent profit on cost risk was assigned. The profit justification did not, however, indicate that the risks in packaging food components and meal packages were covered in loss allowances included in the estimated costs of the prime contract and the subcontracts. The prime contract covered expected packaging losses of about $412,000, and the subcontracts included a loss allowance for scrap. With respect to difficulty in managing subcontracts, a separate allowance had already been included in the initial profit factor for this effort.

Generally, in the past, we have not attempted to evaluate the reasonableness or the adequacy of the amounts of profit that have been agreed upon in negotiations. Such evaluations are difficult to make because of the many intangibles involved and the lack of any accepted standard as to what is a reasonable profit, particularly for fixed-price type contracts where the contractor assumes financial risks and other responsibilities. In this case, however, the cost risk and contracting responsibilities were not properly identified in accordance with DAR. Therefore, the profit objective was overstated. Assuming that the profit objective was determined using the lower rate permitted in DAR (6 percent) for cost risk and that no special profit allowance was included, a profit objective of $2.38 million would have been indicated. The profit actually negotiated in the contract was $3.70 million, or $1.32 million more than would appear to be warranted under the circumstances.

AGENCY COMMENTS AND OUR EVALUATION

Although a draft of this report was submitted to DOD for comment, formal written comments were not provided. However, we did obtain informal oral comments from DOD and Center officials. These officials expressed the view that there was no significant overpricing or defective pricing on this contract. Also, they stated that their selection of a firm fixed-price contract was appropriate.

The views of DOD and Center officials were based on three premises which they believe influenced the negotiations on this contract. The three premises are as follows:

--The procurement involved a production test and there were uncertainties about meeting the specifications.

--The contract price negotiated was based on the total price of the contract and not the individual cost elements that went into the contract.

--The Government would likely suffer severe financial disadvantages in terms of contract price increases if the contract negotiations were reopened to consider defects in the contractor's revised overhead cost estimates identified during the post-negotiation audits.

According to DOD and Center officials, these premises produced an environment whereby the cost risks associated with producing the new combat meals could be shifted to the contractor in a reasonably priced contract. Although they recognized that the contract price was not fully supported by the major cost elements making up the final negotiated fixed-price, DOD and Center officials considered the price to be fair and reasonable and there was no need to reopen contract negotiations. The view that the price was fair and reasonable, we believe, was not supported by the contract record.

The record indicates that the Government's representatives went into negotiation with a low price objective of $20.4 million, a target price objective of $23.3 million and a high price objective of $27.9 million. These price objectives were developed utilizing the results of the DCAA audit of the cost and pricing data submitted by the contractor in support of the original price proposal of $31.2 million. During negotiations the contractor provided a revised price proposal of $36.8 million, an increase of $5.6 million over the original proposal. The increase was largely attributed to substantial increases in overhead costs. As indicated in our report, Center officials should have recognized at this point that the contractor may have been reluctant to assume cost risk because the contractor's estimate was 31 percent higher than the Government's high objective of $27.9 million and

58 percent higher than the target objective of $23.3 million. Under these circumstances continued insistance on contractor assumption of cost risk is likely to encourage, and we believe, actually did result in inflated cost estimates as opposed to reasonable cost estimates.

Concerning the use of a fixed-price contract in this negotiation atmosphere, DAR 3-402 and 3-404.1 provide that fixed-price contracts are appropriate when the contracting effort is not unduly complex and the uncertainty involved in performance can be identified sufficiently to render reasonable estimates of the possible cost impact. As indicated earlier, this contract did not meet these conditions.

Whether or not a contract price is ultimately negotiated on a total price basis, it is still necessary to consider individual cost elements in order to evaluate the reasonableness of that price. The aggregate of the individual cost elements considered acceptable and supportable by DCAA was about $17.9 million, whereas the contract price negotiated was $28.4 million. How individual cost elements were considered in negotiating the contract price should be fully explained in the negotiation memorandum, especially when the final price exceeds the supportable cost elements identified by DCAA and the Government's initial high objective. That is, the record should indicate the extent to which the contracting officer relied on the contractor's cost and pricing data, the cost elements to which he thought any contractor concessions applied, and the basis for accepting or providing concessions. In this case, the negotiation memorandum did not provide the necessary information to support the reasonableness of the contract price. Instead, our review disclosed considerable evidence that the contract price was unreasonable and unsupported by the data the contractor submitted.

Finally, with regard to the view that in reopening negotiations the Government would likely suffer severe financial disadvantages in terms of contract price increases, the Center did not provide an estimate of the possible price impact of the disadvantages nor any further data to support this view. Our review shows that DCAA's report on the audit of the contractor's revised proposal raised serious questions on the appropriateness of about $1 million included in the final contract price, and once again brought the contractor's pyramiding of profits on the interdivisional transfer to the Center's attention. Therefore, without evidence to negate the DCAA findings, the disadvantages of reopening negotiations referred to by Center officials are not apparent.

CONTRACTOR COMMENTS AND OUR EVALUATION

The contractor, in its response of March 25, 1983, to us, stated the conclusions contained in portions of our draft report are not supported by the facts. The contractor also stated the procedures and methods used to negotiate and price the initial contract have in subsequent contracts substantially reduced the cost of the MRE program. The contractor added that without either negotiating party having the benefit of prior production experience to judge the reasonableness of estimated costs, the allowance for costs came within 1 percent of actual costs.

In our view, the comments provided support our conclusion that the contracting officer should not have awarded a fixed-price contract. The contractor agrees there was no previous production history or other basis on which to reasonably estimate proposed costs. However, whether the actual costs closely compare to the estimated costs does not establish the reasonableness of the estimates because the estimates do not provide sufficient incentive to economically perform the contract. Also, there were considerable costs incurred that were not properly comparable to the cost estimates because they were not acceptable in contracting pricing. We believe the most important questions to be resolved are whether the contractor submitted cost or pricing data that was current, complete, and accurate and whether this data supported the contractor's cost estimates.

Concerning these questions, the contractor provided the following additional information.

--The contractor stated that in regard to reimbursement of the $524,000 in special leasehold improvements, the Government has continued to enjoy the benefits of the improvements without additional cost and was better off in the long run for having made this decision. We are not questioning the contractor's action on this point, but as explained earlier, we are questioning the actions of the contracting officer in approving this expenditure. The contractor has offered no new information for our consideration. (See p. 8.)

--In regard to paying 40 cents a square foot to lease a 135,000 square foot facility, the contractor stated the company advised the Government of its decision before the lease was executed and there was not a facility that was remotely comparable to the one contracted for that would meet its needs. We are not questioning the size of the facility, but we are questioning the reasonableness of the data submitted by the contractor to support the 40 cents a square foot lease rate. We believe it was defective because the contractor did not use comparable real estate data in its cost analysis. It should be noted that 80,000 of the 135,000 square foot facility is used by the

contractor to store food. In 1981 MRE leased an additional 50,000 square feet of new warehouse space nearby for 20 cents a square foot, which is one-half the lease rate the contractor signed in October 1979 to rent the 135,000 square foot assembly building. At 20 cents a square foot, the cost to lease the building would have been $325,000 annually, rather than $650,000. (See p. 8.)

--In regard to duplicate subcontract costs with Sterling Bakery, the contractor stated that start-up costs were split between the two prime contractors; the proper freight rate to the prime contractor's location was calculated and included in the contract price; and equipment lease costs were not allowed, but had to be capitalized. These comments, however, conflict with the facts obtained during our review. (See p. 10.)

--In regard to an unexplained $242,000 increase on a subcontract, the contractor stated that Fresh Flavor Meals was a disadvantaged firm that was very unsophisticated in finances and estimating costs. The contractor added that DCAA had questioned many of the subcontractor's cost estimates, but were resolved at contract negotiations when additional support was provided. However, the contractor did not provide us with any evidence that would clarify the unexplained increase. (See p. 11.)

--The contractor stated the firm's purchase of freeze dehydrated items from its Freeze Dry Division was not represented to be competitive. This statement conflicts with the information contained in the price negotiation memorandum. It states the profit on this purchase was accepted by the contracting officer because he believed the price was based on adequate competition, which is an exception to the pyramiding rule. Since this is a factual disagreement between the contractor and the contracting officer, it will have to be resolved by DOD officials when they determine the extent of the contract price adjustment. (See p. 11.)

--The contractor also discussed various overhead and other direct costs dealing with (1) fringe benefit rates, (2) equipment rental/depreciation, (3) travel, (4) component destruction and loss, (5) severance pay, and (6) facilities capital.

Fringe benefit rates

The contractor stated the company provided the Government full information at all times concerning actual previous fringe cost experience and estimates of future rates. In this instance, we are not taking issue with the contractor. Rather, we are questioning the contracting officer's

actions. In both his prenegotiation and negotiation memorandums, the contracting officer failed to explain why he changed the fringe benefit rates that increased the Government's costs by $108,366. (See p. 12.)

Equipment rental/depreciation

The contractor stated the firm was attempting to lease equipment at the time of and after negotiations. Eventually, the company convinced a bank to enter into an operating lease for a portion of the equipment. However, the price negotiation memorandum states that the contractor intended to purchase equipment. No mention was made of the contractor's intent to lease the equipment. This disagreement between the contractor and the contracting officer on data presented during negotiations will have to be resolved when DOD officials determine the extent of the contract price adjustment. (See p. 13.)

Travel

The contractor stated the firm provided the Government all the required data to justify its proposed travel expense. We are not questioning the data provided by the contractor, but we are concerned about the actions taken by the contracting officer in negotiating travel costs. For example, DCAA had informed the contracting officer that $73,400 in proposed travel expense was for five employees connected with the contractor's joint venture partner and was not associated with this contract. Therefore, DCAA advised the contracting officer that the $73,400 was not properly allocable to the contract. However, the contracting officer never discussed the propriety of this travel expense in his memorandum of negotiations. (See p. 14.)

Component destruction and loss

The contractor stated the firm disclosed all estimates and categories of expected loss to the Government in great detail and negotiated a price that was supportable at the time. We do not agree with the contractor that the firm provided adequate cost or pricing data or with the contracting officer's decision in agreeing to allow the contractor $412,546 for this item. The records show the contractor provided the contracting officer a production packaging estimate, a local police captain's estimates of what he thought a manufacturing company could expect in losses, and a "Ripley's Believe It Or Not" article that shows the monetary losses a company could expect from employee theft, which the contractor used to support its component destruction and loss estimates. The contractor did not provide any additional support with its comments.

After negotiations, the contracting officer agreed that 2.25 percent would be a reasonable loss rate to cover food components. The negotiation memorandum did not explain how the 2.25 percent rate was developed and what it was to specifically cover. The contractor's records show total food component losses were $58,046, or $354,500 less than the $412,546 negotiated. (See p. 15.)

Severance pay

The contractor stated the company had orally promised its managers a severance pay arrangement should the MRE contract be terminated or not renewed. Later, the contractor stated a general policy was created to apply to all salaried employees. However, as cited earlier in the report, severance pay allowance is a contingency involving terminations of operations that are an unallowable cost under DAR and should have been excluded from the contract. The contracting officer never addressed this point in his memorandum of negotiations. (See p. 16.)

Facilities capital

The contractor stated the firm purchased substantial capital equipment in addition to that which was leased. Also, substantial down payments were made and outstanding for long periods of time on equipment that was eventually rented under an operating lease from a bank. The contractor is confirming what we have previously stated, that is, since no expenditure was made by the contractor for a capital investment, the contracting officer should have followed the DAR and reopened negotiations to eliminate $71,616 in non-existent capital investment costs. The contracting officer had previously allowed this amount in the March 1980 negotiations because the contractor had planned to make a capital investment. (See p. 16.)

MEALS-READY-TO-EAT (MRE) CONTRACTS

Contract	Cases	Southern Packaging Co.	Right Away Foods (note a)	Per case difference
MRE I	666,720	$39.899		
	666,720		$42.645	$2.746
MRE I, Reprocurement (note b)	366,696	29.488		
	300,024		35.870	6.382
	2,000,160			
MRE II	1,440,000	31.600		
	1,440,000		35.890	4.290
	c/ 1,120,000	32.688		
	4,000,000			
MRE III	1,150,000	Letter contract	Letter contract	
	1,150,000			
	2,300,000			
TOTAL as of July 1, 1982	8,300,160			

a/ Average difference is $4.49 a case on 2,406,744 cases awarded to Right Away Foods in MRE I and II contracts. The price shown does not include the $524,000 paid for leasehold improvements.

b/ Reprocurement of quantity defaulted by a third prime assembly contractor.

c/ Competed between two contractors after production base quantities had been negotiated.