

**GAO**

Report to the Chairman, Committee on  
Government Operations, House of  
Representatives

February 1989

# CONTRACT PRICING

## Contractors Should Provide Historical Vendor Prices to DOD



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United States  
General Accounting Office  
Washington, D.C. 20548

National Security and  
International Affairs Division

B-219741

February 15, 1989

The Honorable John Conyers, Jr.  
Chairman, Committee on Government  
Operations  
House of Representatives

Dear Mr. Chairman:

This report focuses on continuing weaknesses in contractor estimating procedures and practices for treating historical vendor prices. Over the past several years, our work has shown that defense contractors, after agreeing to prime contract prices, typically negotiate lower prices with their vendors. We believe significant contract savings can be achieved if the Department of Defense (DOD) regulations specifically required contractors to develop, maintain, and furnish historical vendor pricing information.

As requested by the former chairman of the Legislation and National Security Subcommittee, House Committee on Government Operations, we testified<sup>1</sup> on September 7, 1988, before the Subcommittee on persistent and continuing problems with contractor cost estimating systems. We also discussed problems with contractors' treatment of historical vendor prices.

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## Continuing Problems With Contractor Treatment of Historical Vendor Prices

Contractors often estimate material purchases of less than \$1 million on the basis of vendor quotations. Our past and current work shows that contractors' failure to consider historical vendor prices has resulted in significant overpricing. Although contractors typically negotiate lower prices than quoted by vendors and suppliers, we found contractors did not always adjust their estimates to reflect vendors' likely price reductions. As a result, contractors are not providing accurate and reliable material estimates. For the contracts we reviewed, actual prices paid to vendors were typically lower than estimates based on quotations. DOD regulations do not contain specific guidance on how contractors should treat historical vendor prices.

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<sup>1</sup>GAO Contract Pricing Audits (GAO/T-NSIAD-88-45, Sept. 7, 1988).

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In June 1987, we reported<sup>2</sup> that, of 538 parts proposed at \$38 million at 6 contractor locations, the contractors purchased the parts for \$1.7 million less than negotiated in prime contract prices. The contractors achieved these lower prices even though contracting officers reduced the proposed prices by \$2 million during negotiations. We also reported that, for 78 of 108 (72 percent) contract proposals reviewed by the Defense Contract Audit Agency (DCAA), the contractors did not adjust their proposals to reflect likely vendor price reductions.

Our recently completed work at four contractor locations<sup>3</sup> shows that problems continue with contractor treatment of historical vendor prices. We examined 86 proposed material purchases valued at less than \$1 million each and found the majority were proposed based on unadjusted vendor quotations.

However, after prime contract negotiations, the four contractors purchased the items for \$2.5 million less, or about 8 percent less, than the estimated prices based on quotations. In many cases, the contractors either solicited additional quotations or requested "best and final offers" from their vendors.

The following examples illustrate the differences between prices accepted by the government during negotiations and the amounts contractors actually paid their vendors.

At Martin Marietta, on one contract we reviewed, 33 material purchases were proposed at \$10.5 million based on vendor quotations. The proposed prices were accepted by the contracting officer. After prime contract award, Martin actually purchased the items for \$692,000 less, or a 7-percent reduction. During our review, Martin officials stated that the company did not routinely use or provide historical price data in its proposals but noted this data was available upon request.

On another contract awarded to Electrospace Systems Incorporated, we reviewed 10 material purchases proposed at \$3,023,765 based on vendor quotations. The contracting officer accepted the proposed prices during prime contract negotiations. After prime contract award, Electrospace

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<sup>2</sup>Contract Pricing: Defense Contractor Cost Estimating Systems (GAO/NSIAD-87-140, June 3, 1987).

<sup>3</sup>Electrospace Systems Incorporated, Richardson, Texas; Martin Marietta Corporation, Electronics and Missiles Group, Orlando, Florida; Hercules Incorporated, Aerospace Products Group, Magna, Utah; and Grumman Aerospace Corporation, Bethpage, New York.

purchased the items for \$675,000 less, or 22 percent lower, than negotiated with the government. According to an Electrospac official, the company does not maintain historical pricing information and to develop such data would be a significant administrative burden.

We believe that if contractors developed, maintained, and furnished historical vendor price information, the government would be in a better position to determine if proposed prices are fair and reasonable. With this information, contracting officers would have an additional tool for evaluating whether the contractor has submitted accurate and reliable material estimates.

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## Historical Pricing Data Is Essential to Good Cost Estimating

Sound cost estimating systems are essential for negotiating fair and reasonable contract prices. When contractors do not maintain and disclose historical vendor pricing information, an estimating system deficiency results, which can cause contract overpricing.

Although DOD procurement regulations do not specifically require contractors to develop, maintain, or disclose historical vendor pricing information, the Deputy Assistant Secretary of Defense (Procurement) issued policy guidance in April 1987 that defined such information as cost or pricing data. The Deputy Assistant Secretary also instructed DOD contracting officers to insist that contractors provide this data.

Acting on the Deputy Assistant's guidance, the Air Force, in October 1987, issued additional guidance requiring its contractors to develop, maintain, and provide historical vendor pricing information. Similar guidance has not been issued by the Army, the Navy, or the Defense Logistics Agency.

The Air Force guidance states that:

“Contractor material estimates are often supported only by vendor quotes even though the contractor knows and anticipates that lower prices will be negotiated later by them. The fallacy of this approach is that the contractor's proposal is overstated and does not represent a reasonable estimate of expected actual cost.”

To further emphasize the importance of historical pricing data, the guidance states:

“Because the decrement factor data reflecting the historical difference between vendors' proposed prices and the actual prices negotiated with the vendor is cost or

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pricing data, the contractor, not DCAA or the ACO [administrative contracting officer], is responsible for maintaining and furnishing this data as support for material prices . . . . Contractor estimating systems that fail to identify, document and include decrement factors in their proposals where appropriate, should be classified as deficient and contractors should be directed to make the necessary changes as soon as possible.”

In March 1988, DOD revised its regulatory guidance on contractor cost estimating systems. The guidance discussed the need for adequate sub-contract evaluations, among other things. We support the revised guidance which, if properly implemented, should result in significant price reductions. However, the March 1988 guidance does not specifically address contractor treatment of historical vendor pricing information.

Further, the DOD Contractor Risk Assessment Guide (CRAG) Program<sup>4</sup> issued in November 1988 attempts to secure contractor participation in providing historical pricing data. According to the CRAG, contractor estimating systems should “provide for the use of historical experience where appropriate including the results of negotiations with subcontractors and suppliers as to price adjustments of initial bids or proposals.”

We support the actions of the Deputy Assistant Secretary of Defense (Procurement), the Air Force, and the CRAG Program to deal with historical pricing information, but more needs to be done. The Deputy Assistant Secretary’s April 1987 policy guidance is not obligatory for contractors, the military services, or the Defense Logistics Agency. The Air Force guidance of October 1987 is applicable only to Air Force contractors. In addition, the CRAG Program is voluntary and contractors have the basic responsibility for deciding the extent, if at all, to which they will participate.

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## Conclusion and Recommendation

We believe DOD procurement regulations should clearly and specifically require contractors to develop, maintain, and provide historical vendor pricing information. Therefore, we recommend that the Secretary of Defense direct DOD personnel to revise DOD procurement regulations to require that contractors develop, maintain, and furnish historical vendor pricing data in support of proposed prices.

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<sup>4</sup>The CRAG Program is designed to encourage DOD contractors to develop more effective contractor internal control systems and to improve DOD oversight. The program covers five risk areas: indirect cost submissions, labor charging, material management and accounting systems, purchasing, and estimating systems.

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## Objective, Scope, and Methodology

Our objective was to determine whether defense contractors provided accurate and reliable material estimates. To accomplish this objective, we reviewed contractor policies, procedures, and practices for estimating material costs included in fixed-price noncompetitive contracts valued at \$10 million or more.

We performed our review at 4 of the top 100 fiscal year 1987 defense contractors and reviewed estimates totaling \$213 million included in 8 prime contracts. Our review included all material purchases exceeding \$100,000, and we examined contract price proposals, priced bills of material, purchasing file documents, and negotiation records. We also interviewed procurement and contracting officials at each location.

We did not obtain official agency comments on this report, but the matters contained in the report were discussed with officials of DOD and the four contractors included in our review. Our review was performed from October 1987 to September 1988 in accordance with generally accepted government auditing standards.

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This report was prepared under the direction of Mr. Paul F. Math, Director, Research, Development, Acquisition, and Procurement Issues. Other major contributors are listed in appendix I.

We are sending copies of the report to appropriate congressional committees; the Secretary of Defense; the Director, Office of Management and Budget; and other interested parties.

Sincerely yours,

*for*   
Frank C. Conahan  
Assistant Comptroller General

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