DEPARTMENT OF DEFENSE

AUDIT REPORT

EVALUATION OF SUBCONTRACT PRICE PROPOSALS

No. 90-057

April 9, 1990

Office of the Inspector General

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Audit of the Evaluation of Subcontract Price Proposals (Report No. 90-057)

This is the final report on the Audit of the Evaluation of Subcontract Price Proposals. Comments on a draft of this report were considered in preparing the final report. We made the audit from October 1987 through May 1989. The initial objectives of the audit were to evaluate procedures used by procurement officials to identify when Government assist audits of subcontractor price proposals were required and to determine the extent that Government assist audit reports were used by procurement contracting officers in negotiating contract prices. During the audit, we expanded our objectives to include the prime contractor's evaluations of subcontractor cost and pricing data. We statistically sampled and reviewed 30 fixed-price contract pricing actions for FY 1987 with a negotiated value of $5.8 billion from a universe of 225 DoD pricing actions valued at $11.7 billion.

The audit showed that DoD procurement officials did not require prime contractors to comply with Defense and Federal Acquisition Regulations' requirements regarding subcontract price proposals. We assessed internal controls that focused on determining compliance with Defense and Federal Acquisition Regulations' requirements. Based on our statistical sample, the audit projected that DoD contracts were overpriced by $94 million because procurement officials did not require prime contractors to submit the results of their subcontract cost analyses before negotiating a fixed contract price and did not protect DoD's interest when subcontract negotiations were not completed until after the Government and prime contractor negotiations were concluded. Also, nine contracts were potentially overpriced by an additional $1,471,202 because contractors did not furnish Government negotiators with accurate, complete, and current cost or pricing data as required by the Truth in Negotiations Act. Although policies and procedures for determining when assist audits were required appeared to be adequate, other subcontract pricing policies were not always enforced by contracting officers,

especially the requirement for detailed supporting data on prime contractor bills of material. Further, internal controls needed to be established to ensure compliance with existing policy. Also, procurement officials did not always use Government assist audit reports, but prime contractors used and frequently benefited from the reports. Prime contractor policies for obtaining and evaluating subcontractors' cost and pricing data closely followed policy in the Federal Acquisition Regulation (FAR). However, prime contractors realized significant savings (projected at $94 million) on proposed subcontracted items by negotiating lower prices with their vendors, after negotiating with the Government. The results of the audit are summarized in the following paragraphs, and the details, audit recommendations and management comments are in Part II of this report.

Prime contractors did not provide the Government with results of their cost analyses for subcontracts that they negotiated subsequent to reaching agreement on prime contract price thereby realizing significant savings. Also, procurement officials did not protect the Government's interest in negotiating a price on these contracts. We projected that 44.7 percent of the noncompetitive subcontracts were negotiated after reaching agreement on contract price. As a result, we estimated that fixed-price contracts were overpriced by $94 million in FY 1987. We recommended that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to procurement officials emphasizing the need to require prime contractors to submit proposals in the required FAR format, obtain and consider the results of all prime contractors' cost analyses before negotiations, and take action to protect the interest of the Government to include negotiated reopener clauses in fixed-price contracts or delay negotiations until major subcontract costs are negotiated. To ensure compliance with FAR requirements, we recommended that the Director, Defense Contract Audit Agency (DCAA), establish internal controls that require DCAA preaward evaluations of prime contractor price proposals to identify subcontracts exceeding $100,000 for which the FAR required cost analyses have not been performed by the prime contractor. In addition, we recommended that the Director, Defense Logistics Agency, issue a policy memorandum that informs administrative contracting officers of the requirement to conduct and to document preanalysis meetings to determine how proposed costs, including subcontracts and major purchases, will be addressed (page 5).

DoD did not receive any benefits from prime contractor analyses and negotiations of competitive and dual-sourced subcontract proposals. We projected that this caused FY 1987 contracts to be overpriced by $13.3 million. We also projected that prime contractors realized $5 million savings by negotiating with, or changing the split among, vendors for items proposed as dual-sourced. These price reductions were not passed on to the DoD. We recommended that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense agencies informing contracting officers of the need to protect the Government's interests by

using a contract reopener clause for significant undefinitized competitive or dual-source subcontract costs when it is known that a contractor has a practice of negotiating competitive quotes or with competitors in dual-source purchasing arrangements. In regard to internal control improvements, we recommended that the Director, DCAA, expand DCAA's audit guidance for estimating systems surveys and price proposal reports to identify contractors who have policies or practices of negotiating competitive or dual-source quotes (page 15).

DCAA performed audits of 76 subcontract proposals within our 30 sampled prime contracts for which the Government did not receive any benefits. As a result, DoD unnecessarily expended $169,742 in DCAA audit resources, and prime contractors used the audit results to contribute toward negotiating $538,869 in subcontract price reductions that were not passed on to DoD. We recommended that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to contracting officers at Military Departments and Defense agencies emphasizing the need to follow up with DCAA on the results of outstanding assist audits before negotiating a firm-fixed contract price. We also recommended that the Commander, U.S. Army Tank-Automotive Command, issue guidance to its contracting officers to ensure that requests for assist audits of subcontract price proposals made subsequent to price negotiations on firm-fixed price contracts are only requested if they have a direct monetary benefit on the immediate contract (page 21).

Nine contractors potentially violated provisions of the Truth in Negotiations Act by not submitting accurate, complete, and current cost or pricing data in support of their contracts. As a result, the nine contracts were potentially overpriced by $1.4 million. We recommended that the commanders of buying commands responsible for issuing these contracts monitor DCAA's progress on the nine potentially defective pricing cases and take appropriate action if necessary (page 27).

During the audit, we found that contracting officers did not always use Government assist audit reports in negotiating contract prices, or they did not document their use of the reports. The Assistant Secretary of Defense (Production and Logistics) issued policy memorandums in 1987, 1988, and 1989 to the Military Departments and Defense agencies that emphasized to contracting officers the requirement to document the use of assist audit results in contract price negotiations. These memorandums should correct the noted deficiency. Therefore, we have deleted the draft audit finding on Use of Government Assist Audits from this report.

Internal controls were evaluated as applicable to the stated audit objectives. The audit identified internal control weaknesses, as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Adequate procedures were not established to ensure compliance with existing policy. Recommendations made to Finding A. in this report, if

implemented, will correct the weaknesses; however, we could not determine the monetary benefits to be realized by implementing these recommendations. The monetary benefits were not readily identifiable because prospective benefits would be based on undeterminable future procurement requirements. The senior official responsible for internal controls within the Office of the Assistant Secretary of Defense will be provided a copy of the final report.

On October 5, 1989, a draft of this report was provided to the Assistant Secretary of Defense (Production and Logistics), the Comptroller of the Department of Defense, the Assistant Secretary of the Army (Financial Management), the Assistant Secretary of the Navy (Financial Management), the Assistant Secretary of the Air Force (Financial Management and Comptroller), the Commander, U.S. Army Tank-Automotive Command, and the Directors of the Defense Logistics Agency and the Defense Contract Audit Agency. Management comments were received from the Assistant Secretary of Defense (Production and Logistics) (Appendix J), the Comptroller of the Department of Defense (Appendix K), the Army (Appendix L), the Navy (Appendix M), the Air Force (Appendix N), the Defense Contract Audit Agency (Appendix O), and the Defense Logistics Agency (Appendix P).

The following table shows a cross reference between recommendations in the draft report and those in this final report.

Recommendation References As Shown

In Draft Report	In Final Report
A.1.d.	Combined with A.1.c.
B.2.	Deleted
B.3.	B.2.
C.1.	Deleted
C.2.	Deleted
D.1.a.	C.1.
D.1.b.	C.1.
D.1.c.	C.1.
D.2.	Deleted
D.3.a.	C.2.a.
D.3.b.	C.2.b.
E.1.a.	D.1.a.
E.1.b.	D.1.b.
E.2.a.	D.2.a.
E.2.b.	D.2.b.
E.3.a.	D.3.a.
E.3.b.	D.3.b.

All references are to final report recommendations except where noted.

The Assistant Secretary of Defense (Production and Logistics) nonconcurred with Recommendations A.1.a., A.1.b, A.1.c., A.1.d., A.2., and B.1., to issue policy memorandums emphasizing existing

guidance. The Assistant Secretary stated that numerous policy memorandums and regulatory and statutory changes have occurred over the past few years and since our report was based on contract actions occurring during fiscal year 1987, the results of many corrective actions would not yet be reflected in the contracts we audited. The Assistant Secretary partially concurred with Recommendation C.1. stating that a policy memorandum will be issued that emphasizes followup with DCAA on outstanding assist audits before agreement on a final price. We consider the Assistant Secretary's comments to Recommendation C.1. to be responsive to the intent of the finding and recommendation. However, the Assistant Secretary did not provide an estimated date for the completion of planned actions, and we therefore ask that he do so.

We agree that many corrective actions have been promulgated in recent years. On the basis of the Assistant Secretary's comments, we deleted draft report Finding C. and draft Recommendations C.1. and C.2., which addressed the need to emphasize the use of assist audit report results during the negotiation process. Also, we reevaluated the materiality of internal control weaknesses. Based on our reevaluation and the Assistant Secretary's comments, we deleted draft report Recommendations B.2. and D.2., which addressed material internal control weaknesses. We reworded Recommendation A.1. to clarify our intent. We still consider Recommendations A.1.a, A.1.b, A.1.c, A.2., and B.1. valid for reasons discussed in Part II of the report. Therefore, we ask that the Assistant Secretary of Defense (Production and Logistics) reconsider his position on Recommendations A.1.a, A.1.b, A.1.c, A.2. and B.1. in responding to the final report. Also, we ask that the Assistant Secretary respond to the final report indicating concurrence or nonconcurrence with the revised recommendations.

Although no recommendations were addressed to the Comptroller of DoD, the Comptroller concurred with draft Recommendations C.1., D.1.a., and D.3.

DCAA concurred in principle with Recommendation A.3. to establish a requirement to identify, in its Reports on Evaluation of Initial Price Proposal, those purchase orders and subcontracts exceeding $100,000 for which the required cost analyses had not been performed by the prime contractor. DCAA stated that guidance would be issued establishing a requirement that Audit Reports on Evaluation of Initial Price Proposals identify purchase orders and subcontracts for which the FAR 15.806-2(a) required cost analysis has not been performed by the prime contractor. DCAA nonconcurred with Recommendation B.2. that its estimating system survey reports identify contractors who have policies or actual practices of negotiating competitive or dual-source quotes. DCAA stated that its reports currently provide information in relation to contractors who negotiate competitive or dual-source quotes through their use of decrement factors. It also stated that details supporting the decrement factors are presented in both estimating systems survey reports and price proposal reports.

Although we do not disagree with DCAA's comments, they do not address the intent of our recommendations. Recommendation B.2. has been expanded to include price proposal reports, and reworded to be more specific. We believe that both recommendations are still valid for reasons discussed in Part II of this report. Therefore, we are asking that DCAA reconsider its position on Recommendations A.3. and B.2. in responding to the final report.

The Army nonconcurred with Finding C because it felt that the Government did receive benefits from postaward subcontract assist audits via negotiated decrement factors. However, the Army did concur with Recommendation C.2.a. and partially concurred with Recommendation C.2.b. Also, the Army concurred with Recommendation D.3. We consider its comments to Recommendations C.2.a, and D.3. to be responsive. We still consider Finding C to be valid for reasons stated in Part II of the report and request that the Army reconsider its position in responding to the final report. In our opinion, the Army's proposed guidance in response to Recommendation C.2.b. does not fully comply with the intent of our recommendation. Therefore, we believe that the recommendation in the draft report is still warranted for reasons discussed in Part II of the report.

The Navy nonconcurred with Recommendation D.1.a. to request the cognizant procurement contracting officers to monitor the progress of DCAA offices' defective pricing reviews. The Navy believes that neither is it appropriate nor is there time for Navy contracting officers to monitor DCAA auditors. However, the Navy did state that it would take appropriate action if DCAA notified it about contractor defective pricing. The Navy concurred with Recommendation D.1.b. Although the Navy stated nonconcurrence with Recommendation D.1.a, we believe the planned action complies with the intent of Recommendations D.1.a and D.1.b.

The Air Force concurred with Recommendation D.2., and we consider its comments to be responsive.

The Defense Logistics Agency partially concurred with Recommendation A.4. The planned actions of the agency are responsive to the intent of the finding and recommendation.

DoD Directive 7650.3 requires that all audit recommendations be resolved within 6 months of the date of the final report. Accordingly, we request that all addressees provide final comments on the unresolved issues in recommendations addressed to them within 60 days of the date of this memorandum. The comments should indicate either concurrence or nonconcurrence with the findings and each recommendation addressed to you. If you concur, describe the corrective actions taken or planned, the completion dates for actions already taken, and the estimated dates for completion of planned actions. If you nonconcur with either the findings or the recommendations, please state your specific reasons. If appropriate, you may propose alternative methods to accomplish the desired improvements. This report contains undeterminable monetary benefits. We were unable to project

monetary benefits because any prospective cost avoidance would be based on undeterminable future requirements. We also ask that your comments indicate concurrence or nonconcurrence with the internal control weakness described above. DoD Directive 7640.2, "Policy for Followup on Contract Audit Reports," does not pertain to this report.

The courtesies extended to the audit staff are appreciated. Copies of the final report will be distributed to the activities listed in Appendix R. The audit team members are listed in Appendix S. Please contact Mr. Salvatore Guli, Program Director, at (202) 694-6285 (AUTOVON 224-6285), or Mr. James R. Peterson, Project Manager, at (202) 693-0594 (AUTOVON 223-0594) if you have any questions on this report.

Edward R. Jones
Deputy Assistant Inspector General
for Auditing

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force
Comptroller of the Department of Defense

REPORT ON THE AUDIT OF THE EVALUATION OF SUBCONTRACT PRICE PROPOSALS

TABLE OF CONTENTS

	Page
TRANSMITTAL MEMORANDUM/EXECUTIVE SUMMARY	i
PART I - INTRODUCTION	1
Background	1
Objectives and Scope	1
Internal Controls	3
Prior Audit Coverage	3
PART II - FINDINGS AND RECOMMENDATIONS	5
A. Prime Contractors Realize Significant Savings on Subcontracted Items	5
B. Analysis of Competitive Subcontractor Proposals	15
C. Government Assist Audits Published After Contract Price Negotiations	21
D. Potential Defective Pricing of Nine Contracts	27
Appendixes	See next page

Prepared by:
Contract Management Directorate
Project No. 8CE-0001

LIST OF APPENDIXES

	Page
APPENDIX A - Schedule of Sampled Contracts	31
APPENDIX B - Sample Methodology	33
APPENDIX C - Schedule of Federal Acquisition Regulation Required Supporting Data Frequently Omitted From Contractors' Price Proposals	35
APPENDIX D - Schedule of Contracts With Unanalyzed Subcontract Proposals at Time of Field Pricing Report	37
APPENDIX E - Defense Logistics Agency Contract Administration Offices Visited	39
APPENDIX F - Schedule of Contractors Attempting to Obtain Price Reductions on Competitive Quotes	41
APPENDIX G - Assist Audits Published After Contract Negotiations	43
APPENDIX H - Schedule of Contracts With Potential Defective Pricing	45
APPENDIX I - Potential Monetary Savings and Other Benefits	47
APPENDIX J - Assistant Secretary of Defense (Production and Logistics) Comments	49
APPENDIX K - Comptroller of the Department of Defense Comments	57
APPENDIX L - Army Comments	59

LIST OF APPENDIXES (Continued)

	Page
APPENDIX M - Navy Comments	67
APPENDIX N - Air Force Comments	79
APPENDIX O - Defense Contract Audit Agency Comments	81
APPENDIX P - Defense Logistics Agency Comments	85
APPENDIX Q - Activities Visited or Contacted	89
APPENDIX R - Final Report Distribution	93
APPENDIX S - Audit Team Members	95

REPORT ON THE AUDIT OF THE EVALUATION OF SUBCONTRACT PRICE PROPOSALS

PART I - INTRODUCTION

Background

Defense and Federal Acquisition Regulations include procedures to ensure that subcontract costs, negotiated as part of the prime contract price, are fair and reasonable. The prime contractor is responsible for obtaining cost or pricing data from prospective subcontractors, conducting appropriate cost analyses before awarding subcontracts, and providing the results of their cost analyses of subcontractor proposals to the Government as part of their own submission of cost and pricing data. In some situations, the prime contractor cannot evaluate the prospective subcontractor's cost or pricing data. This situation often occurs when the prime contractor and subcontractor are competing for the award of the same, or a related, contract. The subcontractor may refuse to allow the prime contractor's auditors into its plant because it does not want the prime contractor to have access to its estimating methods and procedures. When this situation occurs, the prime contractor is responsible for reporting the condition to the contracting officer so that Government auditors can perform the review. Further, business relationships between the prime contractor and subcontractor may not be conducive to independence and objectivity, i.e., related companies. In addition, contracting officers may request Government assist audits of subcontract proposals at any time that it is considered necessary to ensure the reasonableness of the prime contract price.

Although procurement contracting officers are responsible for negotiating a final contract price, they obtain assistance from contract auditors, price analysts, and technical specialists who evaluate the cost elements in prime contractor proposals and recommend ways to achieve fair and reasonable prices. These evaluations include an analysis of subcontract costs that are proposed by prime contractors.

Objectives and Scope

Our initial objectives were to evaluate procedures used by procurement officials to identify when Government assist audits of subcontractor price proposals are required and to determine the extent that Government assist audits are used by procurement contracting officers in negotiating contract prices. The basic criteria are contained in the Federal Acquisition Regulation (FAR), subpart 15.8-Price Negotiations; the Defense Federal Acquisition Regulation Supplement (DFARS) subpart 215.8-Price Negotiations; and in local activity supplements. Subcontracts are defined in FAR subpart 44.101 to include purchase orders and

modifications to purchase orders. We reviewed contract files, pricing case files, field pricing reports and related files, prime contractor records, correspondence files and other documentation as necessary at procurement and administrative contract offices, the prime contractor plant and cognizant Defense Contract Audit Agency (DCAA) offices. We focused on pre- and post-price negotiation and business clearance memorandums, field pricing reports, and preaward pricing and assist audit reports.

We expanded our objectives during the audit to include an evaluation of prime contractor procedures for obtaining and analyzing subcontractor cost and pricing data. Prime contractors issued their own guidance, which generally followed the FAR and DFARS. Documents reviewed included prime contractor proposals, cost analyses, subcontract negotiation memorandums, and actual purchase order files. We focused on prime contractors' bills of material and any other documentation provided to the Government that identified major subcontracts.

During our review of prime contractor cost or pricing data that supported proposed subcontracts, we determined whether any subcontract overpricing was a result of violating the Truth in Negotiations Act. We did not review the other cost elements of a prime contractor's proposal because doing so would have been outside the scope of our audit. All potential defective pricing was referred to the cognizant DCAA office for inclusion in its contract pricing reviews at the prime contractor plant.

We statistically sampled 30 fixed-price contract actions on FY's 1986 and 1987 contracts that were negotiated during FY 1987 with a minimum value of $10 million. The Individual Contracting Action Report, form DD350, was used to determine the universe. A schedule of the 30 contracts is in Appendix A and the sampling plan is in Appendix B. To review the 30 contracts, we visited 92 activities, including 27 prime contractor locations and 22 DoD buying commands, shown in Appendix Q.

This economy and efficiency audit was made to determine whether contract audit resources are properly used by contracting officers in negotiating a contract price, whether applicable laws and regulations were followed, and whether DoD is paying fair and reasonable prices for goods and services. The audit was conducted from October 1987 through May 1989. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD, and accordingly, included such tests of internal controls as considered necessary. The audit focused on items proposed by prime contractors as noncompetitive procurements and, when time permitted, we included competitive items in our review.

Internal Controls

The internal control review focused on determining compliance with the FAR and DFARS requirements regarding subcontract price proposals in prime contractor proposals. The internal control review also focused on determining whether proposed subcontract costs were accurate, current, and complete as required by Public Law 87-653, "Truth in Negotiations Act," as amended. We found material weaknesses, which are addressed in Finding A in Part II of the report.

Prior Audit Coverage

Air Force Audit Agency Report, "Subcontract Pricing on Negotiated Fixed-Price Type Prime Contracts," Project 7076411, was issued on June 21, 1988. This report stated that contracting officers did not perform adequate preaward reviews of subcontract costs before entering negotiations, did not request Government specialists' analyses of updated cost or pricing data received just before or during negotiations, or did not require the prime contractors to submit their analyses of proposed subcontract costs. This report also stated that price negotiation memorandums did not always summarize all the required subcontract cost data.

The report recommended that the Air Force delay negotiations until complete subcontractor cost and pricing data have been analyzed by field activities for the original proposal and for significantly revised proposals, the Air Force provide contractual reopening provisions when subcontracts represent a significant cost risk and negotiation delays are unacceptable, and the Air Force definitize major critical subcontracts before awarding the prime contract.

In its comments to the final report, Air Force officials concurred with the above-stated recommendations and stated that coverage would be included in the Air Force FAR Supplement. The Supplement has been revised to address delaying negotiations and definitizing critical subcontracts. However, the Air Force has not implemented the recommendation regarding the use of contract reopener clauses.

The House Committee on Government Operations report, "Continuing Violations of the Truth in Negotiations Act and Estimating Systems Deficiencies Result in Excess Contractor Profits," House Report 100-1026, dated October 3, 1988, stated that:

> Among other things, GAO found that estimating systems did not produce reliable and supportable proposals because contractors (1) failed to perform subcontract cost reviews as required by DoD procurement regulations, (2) proposed vendor quotations without considering that prices paid to vendors are typically lower than quoted, and (3) relied excessively on judgment although historical data was available.

The report also stated:

> GAO's recent examination of 86 material purchases valued at less than $1 million each found that contractors negotiated prices about 8 percent lower than the prices negotiated in prime contracts. The prices proposed by contractors normally did not consider reductions likely to be achieved in vendor negotiations.
>
> Twenty-three of the material purchases were proposed as competitive and contracting officers accepted the prices as firm believing no further negotiations would occur. Like the Westinghouse case, some contractors solicited additional quotations and negotiated prices significantly lower than the amounts included in prime contracts.

Department of Defense Inspector General (DoDIG) Report No. 87-092, "Effectiveness of the Negotiation Process," was issued on February 26, 1987. This report stated that contracting officers were not always using or documenting their use of field pricing reports in developing negotiation objectives and in the price negotiation memorandums as required by the FAR. In response to this report, the Assistant Secretary of Defense (Acquisition and Logistics) issued a memorandum, dated February 11, 1987, to the Military Departments and Defense agencies emphasizing the need to ensure compliance with FAR requirements for requesting and using field pricing reports.

In response to General Accounting Office reports issued in 1985 and 1986, the Assistant Secretary of Defense (Acquisition and Logistics) issued a memorandum, dated April 6, 1987, to the Military Departments and Defense agencies. This memorandum indicated that prime contractors often were not providing the Government with analyses of subcontract cost or pricing data before negotiations of the prime contract price. The memorandum stated that it was the contracting officers' responsibility to obtain these data in a timely manner so that they could be effectively used during prime contract negotiations.

Our audit disclosed that conditions similar to those reported by the Air Force, the General Accounting Office, and the DoDIG continue to exist within DoD. These conditions are addressed in Findings A., B., C., and D. in Part II of the report.

PART II - FINDINGS AND RECOMMENDATIONS

A. Prime Contractors Realize Significant Savings on Subcontracted Items

FINDING

Prime contractors realized significant savings on subcontracted items by not providing the Government with the results of their subcontract cost analyses for subcontracts that they negotiated subsequent to reaching agreement on prime contract price. This occurred because DoD procurement officials were not taking sufficient actions to ensure that subcontract cost or pricing data were complete and submitted in a timely manner as required by the Federal Acquisition Regulation (FAR). Also, procurement officials did not protect the Government's interest when subcontract negotiations were not completed until after Government/prime contractor negotiations. We found that 44.7 percent of noncompetitive subcontracted items were negotiated by prime contractors after reaching agreement on contract price with the Government. Prime contractors also negotiated competitive and dual-source subcontracts after negotiating final contract prices with the Government. We have addressed negotiations of competitive subcontracts in Finding B. We projected that prime contractors negotiated subcontract cost reductions totaling $94,111,502 after negotiations were completed with the Government. However, the savings were not passed on to DoD. As a result, FY 1986 and FY 1987 firm-fixed-price contract actions, negotiated at $10 million or more in FY 1987, were overpriced by $94 million in base subcontract costs.

DISCUSSION OF DETAILS

Background. Early identification of subcontracted items requiring detailed cost analyses is an integral part of reviewing prime contractor proposals. By identifying items early, procurement officials have the best opportunity to ensure that an adequate proposal evaluation is made before entering negotiations. Certified cost or pricing data are required for noncompetitive subcontracts costing more than $100,000 according to the FAR subpart 15.804, and the Defense Federal Acquisition Regulation Supplement (DFARS) subpart 215.804. Furthermore, when subcontractors are required to submit cost or pricing data to the prime contractor, according to FAR subpart 15.806, the prime contractor is required to conduct cost analyses of the data and submit the results of the analyses as part of their proposal. Prime contractor proposals are required to be in FAR table 15-2 format, which identifies nine items of data for each proposed subcontract. At any time, the contracting officer may request a Government assist audit of a subcontract proposal, regardless of whether the contractor has performed an analysis, if the contracting officer believes that an audit is necessary to ensure reasonableness of the total proposed price according to FAR subpart 15.805-5(i). The Defense Contract Audit Agency (DCAA)

Contract Audit Manual (DCAAM) 7640.1, chapter 9-104, requires the prime contract auditor to specifically review each pricing submission and advise the contracting officer of the need for subcontractor assist audits. The Defense Logistics Agency (DLA) Contract Administration Manual for Contract Administration Services (DLAM) 8105.1, section 15.805-11, requires DLA financial services personnel to coordinate with the contract auditor and technical specialists in establishing a review and evaluation program for contractor proposals and that preanalysis meetings be conducted and documented for significant proposals (usually those exceeding $100,000). This coordination should identify who will be responsible for providing audit and analysis coverage of the entire proposal, including proposed subcontracted costs.

The early identification of subcontracted costs, the required analyses and assist audits, and the use of results of analyses and assist audits are instrumental in developing the Government's negotiating objective for contract negotiations. For example, our review of Grumman Aerospace Corporation contract N00019-86-C-0096 showed that 50 percent of subcontract proposals were analyzed and negotiated before Government and prime contractor negotiations. For subcontract proposals that were analyzed before, but negotiated by the prime contractor after Government negotiations, the Government had ample time to evaluate the prime contractor's analyses and to develop a negotiating objective based on the analyses. Based on a comparison of the Government negotiated subcontract cost (from the price negotiation memorandum) with the actual subcontract cost paid, the Government and prime contractor agreed to subcontract prices that were $998,288 less than what the contractor negotiated with its subcontractors. However, our review of the Texas Instruments, Inc., contract N00019-86-C-0326, showed that the majority (33 out of 41) of subcontract proposals were analyzed by the prime contractor after Government and prime contractor negotiations. Thus, the results of the analyses were unavailable to the Government to consider in developing a negotiating objective to ensure a fair and reasonable price. This situation resulted in a $2,947,635 savings to the prime contractor, but the Government did not receive any compensation.

Proposals Not Submitted in FAR Table 15-2 Format. When prime contractors are required to submit cost and pricing data, the data are to be submitted on Standard Form 1411 along with supporting attachments to satisfy the FAR instructions and appropriate format of table 15-2 in FAR subpart 15.804-6. Table 15-2, among other things, requires a listing of subcontract items showing nine descriptive elements for subcontracts exceeding $100,000. The elements are source, item, quantity, price, type of contract, degree of competition, basis for establishing source and reasonableness of price, as well as the results of a review and evaluation of subcontract proposals.

Our review of 30 contract proposals disclosed that none were in table 15-2 format as required. A listing or bill of material for subcontracted items was included in all except one proposal; however, many descriptive elements were not included in the

listing. Usually the source, item, quantity, and price were listed. However, 25 of 30 contract proposals did not identify type of contract, degree of competition, or basis for establishing source and reasonableness of price (Appendix C). Additionally, none of the 30 identified results of the prime contractors' cost analyses. A properly documented bill of material would allow the contracting officer to identify subcontracts that required contractor analyses or Government assist audits. Our review disclosed that procurement officials who chose to obtain this information usually had to ask for it separately. With this information available at the initial proposal, all unanalyzed subcontract proposals would be identified and the contracting officer should be able to monitor the prime contractor's analyses progress more effectively. Additionally, the need for potential assist audits would be identified and this action would result in more timely analyses. These analyses would then be available to develop a Government negotiation position. (See Finding C. for further discussion of the use of Government assist audits.)

Contractors Analyze Subcontracts After Government and Prime Contractor Negotiations. Our audit projected that prime contractors did not perform 12.5 percent of the required cost analyses of subcontracted items until after the Government and prime contractor negotiations were conducted. These postaward analyses are in noncompliance with FAR subpart 15.806, which requires the prime contractor to perform cost analyses of subcontract proposals and submit the results as part of its own cost or pricing data submission. We believe that this situation was caused, in part, by prime contractors not identifying subcontract proposals that require analyses early in the procurement process. We projected that subcontracted items that were analyzed and negotiated after Government and prime contractor negotiations accounted for $16.8 million of the $94 million in overpricing.

Reopener Clauses Not Included in Contracts. A reopener clause provides a way for the Government and prime contractor to share in cost savings negotiated by the prime contractor with its subcontractors. A reopener clause may be appropriate when the prime contractor has not negotiated final subcontract prices. Reopener clauses allow the contract price to be adjusted after award of the prime contract. Although our audit projected that 44.7 percent of proposed noncompetitive subcontract items were negotiated by the contractor after reaching agreement on a contract price with the Government, we found only one contract, DAAE07-87-C-A001 with Cummins Engine Co., with a reopener clause (for only one subcontract) to protect the Government's interest. In general, decrement factors were used on the remaining contract actions. Decrement factors are based on the prime contractor's historical cost paid to subcontractors. They represent the difference between the proposed subcontract cost and the actual negotiated cost paid by the prime contractor. Once developed, the

decrement factor is applied to the current undefinitized costs proposed by the subcontractor to obtain a reasonable estimated price.

The reopener clause should clearly identify the amounts and which subcontracts were questionable during negotiations. To protect the Government's interest, the contracting officer should include a clause similar to the one found in DoD FAR Supplement, subpart 215.806, which states:

> Promptly upon the establishment of firm prices for each of the subcontracts listed below, the Contractor shall submit, in such form and detail as the contracting officer may reasonably require, a statement of costs incurred in the performance of such subcontract and the firm price established therefor. Thereupon, notwithstanding any other provisions of this contract as amended by this modification, the Contractor and the Contracting Officer shall negotiate an equitable adjustment in the total amount paid or to be paid under this contract to reflect such subcontract price revision. The equitable adjustment shall be evidenced by a modification to this contract.

Our projections show that fixed-price contracts exceeding $10 million and negotiated in FY 1987 were overpriced by $94 million. Our projected overpricing is a net figure that considers the Government's negotiating objectives and any decrement factors applied by contracting officers during negotiations. It appears that using reopener clauses in contracts, when significant subcontracts have not been negotiated, may be more appropriate than using decrement factors. For example, on Raytheon Company contract DAAH01-86-C-0262, the contracting officer applied a 4.5-percent decrement factor to undefinitized subcontract items proposed at $4,654,842 resulting in a negotiation reduction of $209,468. However, the contractor negotiated an additional savings of $392,309 with its subcontractors on those items. This savings was not passed on to the Government. The same situation occurred with Boeing Military Airplane Company contract F34601-87-C-2269. The contracting officer applied a 16.5-percent decrement factor to undefinitized subcontract items proposed at $2,103,738 resulting in a negotiation reduction of $347,117 on the contract. However, the contractor was still able to negotiate an additional $193,579 savings that was not passed on to the Government.

Preaward Analysis Reports Should Identify Subcontracts Requiring Cost Analysis. Field pricing reports, including DCAA's audit reports on evaluation of an initial price proposal, should comment on and identify purchase orders or subcontracts exceeding $100,000 for which FAR required cost analyses had not been performed by the prime contractor. Our review showed that 20 of 30 contracts had contractor analyses remaining to be accomplished when field pricing reports were submitted (Appendix D). However, the unanalyzed subcontract cost proposals were not identified in

12 of the 20 field pricing reports. DCAAM 7640.1, chapter 9-103.1.e., requires coordination between the plant representative or Administrative Contracting Officer and the prime contract auditor in arranging for any supplementary analysis of subcontract or intracompany proposals by the prime contractor or Government field personnel. Also, the DCAA Audit Program for Price Proposals requires the prime contract auditor to determine whether major subcontractor costs have been evaluated by the prime contractor in accordance with the FAR. Because DCAA's audit workpapers contain information regarding unanalyzed subcontract proposals, it is a logical step for DCAA auditors to summarize the information in their preaward analysis reports. The following are three examples of this type of information being included in DCAA Preaward Evaluations.

--DCAA Audit Report No. 2401-6D2220.001S1:

> We recommend prior to Government negotiations with the contractor that updated quotations be obtained for the competitive items and cost or pricing data (SF-1411) be obtained in accordance with FAR 15.804-2(a) for the non-competitive items and the contractor perform a cost or pricing analysis on the current data in accordance with FAR 15.806(a) or a Government assist audit be obtained with FAR 15.805-5(a)(i).

--DCAA Audit Report No. 2491-7A210044:

> We recommend that the contractor be required to complete and provide a cost or price analysis of the proposed costs to the Government representative prior to negotiations, as required by FAR 15.806(a) and (b).

--DCAA Audit Report No. 2441-6C210309(015):

> (The contractor usually) . . . obtains full and complete SF form 1411's from its vendors and performs cost and price analyses as required by FAR 15.806. Accordingly, the contractor should be required, prior to negotiation of this proposal, to obtain the aforenoted vendor quote data, adjusted to reflect contractor/Government audit evaluation as applicable.

These are examples of the type of information that we believe should be provided in all field pricing reports. However, we believe the reports should go one step further and specifically identify all unanalyzed subcontract proposals. Documenting subcontracts and purchase orders that do not have required FAR analyses would inform the contracting officer and other procurement officials of FAR required analyses that may not have been identified in the prime contractor's proposal. Identification of unanalyzed subcontract costs in field pricing

reports should lead to a more thorough proposal evaluation and development of a better Government negotiation position by the contracting officer.

Contract administration offices are required by DLAM 8105.1, section 15.805 to evaluate and incorporate the effect of DCAA audit findings, which would include material and subcontract cost elements, into comprehensive pricing reports. The reports, which are used by contracting officers to develop a Government negotiating position, should also identify subcontract costs where prime contractors have not performed the FAR required cost analyses.

Preanalysis Meetings Not Held or Documented. DLA contract administration offices were responsible for 18 of the 30 contracts in our sample. We did not find any record of preanalysis meetings being conducted and documented by 12 of the 18 DLA facilities (Appendix E), as required by DLAM 8105.1, section 15.805-11. Documentation of these meetings is required for significant contract actions to establish a review and evaluation program for contractor proposals, to readily identify subcontracts requiring contractor analyses or Government assist audits, and to establish the party responsible for ensuring coverage of the area. In establishing the program, DLA personnel are supposed to coordinate with the contract auditor and technical specialists and discuss how to minimize duplication of analysis efforts. If these meetings are not held or if they are held, but not documented, management cannot be assured that an adequate proposal evaluation was conducted. A preanalysis meeting is another way for early identification and subsequent monitoring of subcontracts requiring contractor analyses. Although Navy and Air Force regulations require coordination of efforts among procurement personnel, there is no specific requirement for documenting preanalysis meetings. However, we observed ample evidence that coordination was taking place among personnel, and therefore, we believe that a recommendation to Navy or Air Force is not required.

RECOMMENDATIONS FOR CORRECTIVE ACTION

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to Military Departments and Defense agencies emphasizing the need for contracting officers to require prime contractors to:

a. Submit proposals in Federal Acquisition Regulation table 15-2 format,

b. Obtain results of prime contractor's cost analyses before negotiations, and

c. Take action to protect the interest of the Government when subcontract costs are undefinitized at the time of contract price negotiations on fixed-price contracts. These actions should include applying decrement factors to the proposed price of undefinitized subcontracts, using negotiated reopener clauses

when substantial subcontract costs have not been negotiated before agreement on price, or delaying contract negotiations until significant subcontracts have been negotiated.

2. We recommend that the Assistant Secretary of Defense (Production and Logistics) report as material internal control weaknesses in the annual Statement of Assurances the noncompliance with the Federal Acquisition Regulation and DoD FAR Supplement regarding prime contractor cost analyses of subcontract price proposals and track the deficiencies using procedures established in DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

3. We recommend that the Director, Defense Contract Audit Agency, issue guidance establishing a requirement that Audit Reports on Evaluation of Initial Price Proposal identify purchase orders and subcontracts exceeding $100,000, for which the Federal Acquisition Regulation required cost analyses have not been performed by the prime contractor.

4. We recommend that the Director, Defense Logistics Agency, issue a policy memorandum to financial services personnel emphasizing the requirement to conduct and document preanalysis meetings, which establish the party responsible for analysis of each proposed cost element.

MANAGEMENT COMMENTS

Assistant Secretary of Defense (Production and Logistics). The Assistant Secretary of Defense (Production and Logistics) nonconcurred with draft Recommendations A.1.a., A.1.b., A.1.c., A.1.d., and A.2. He indicated that there was no need to emphasize the submission of price proposals in Federal Acquisition Regulation (FAR) table 15-2 format because of an August 1989 revision to the FAR, which clarified the types of information prime contractors must submit. Also, he stated that recent emphasis on subcontract pricing was sufficient. The Assistant Secretary felt that further emphasis at this point was not warranted because policy memorandums issued in November 1985 and April 1987 had restated the FAR requirement that contracting officers obtain prime contractor analyses of subcontract cost or pricing data and revisions to FAR 15.8 had clarified the Government's and prime contractor's role in subcontract pricing. He believed that current regulations and a memorandum issued from his office in April 1987 provide appropriate emphasis on the use of decrement factors. The Assistant Secretary further indicated that the use of reopener clauses would significantly delay the negotiation of, or eliminate the use of firm-fixed-price contracts. Finally, the Assistant Secretary stated that we had not identified a material internal control weakness because the reported problems were known and not new, and he believed that had we reviewed more recent contract actions, the results would be

significantly different because of increased emphasis placed on the issues. The full text of the Assistant Secretary's comments is in Appendix J.

Defense Contract Audit Agency. The Defense Contract Audit Agency personnel concurred in principle with Recommendation A.3., stating that they will issue guidance establishing a requirement that Audit Reports on Evaluation of Initial Price Proposals identify purchase orders and subcontracts for which the FAR 15.806-2(a) required cost analyses have not been performed by the prime contractor, i.e., purchase orders or subcontracts estimated at $1,000,000 or more, or both more than $100,000 and more than 10 percent of the prime contractor's proposed price. The complete text of the Defense Contract Audit Agency comments is in Appendix O.

Defense Logistics Agency. The Defense Logistics Agency (DLA) partially concurred with Recommendation A.4., stating that a policy memorandum will be issued to Financial Services personnel emphasizing the requirement to conduct and document preanalysis meetings. Planned corrective action was estimated to be completed by December 21, 1989. The full text of the DLA comments is in Appendix P.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Assistant Secretary of Defense (Production and Logistics). During the audit, we were fully aware of the policy memorandums of November 1985 and April 1987 as well as revisions and clarifications to the FAR and DFARS. However, we believe that the conditions that we reported for the contract pricing actions of fiscal year 1987 continue to exist today. Based on our discussions with contracting officers during the audit, which ended in May 1989, we perceived that many contracting officers were still unaware of, or unwilling to enforce, the current FAR or DFARS requirements. During the audit, we asked contracting officers if they required prime contractors to submit their proposals in FAR table 15-2 format. Some contracting officers had to refer to the FAR to see what format we were citing. One contracting officer, in September 1988, indicated that this was "the first time he had seen that (Table 15-2 format), but if you waited for the contractor to provide that data, you would never complete negotiations." Due to staffing problems not all prime contractor personnel performed the required analyses prior to negotiations.

Many problems identified in our report are the result of noncompliance with the FAR and DFARS, e.g., submitting proposals in table 15-2 format and obtaining results of prime contractor cost analyses prior to negotiations. We do not believe that recent FAR and DFARS clarifications alone will make contracting officers and prime contractors comply with these regulations. Although increased emphasis during estimating systems surveys may improve compliance, we believe that contracting officers' enforcement of the FAR and DFARS, on an individual contract basis,

will lead to significant improvements in the area of subcontract pricing. Therefore, we maintain that Recommendations A.1.a. and A.1.b. are still correct as written. Regarding decrement factors and reopener clauses, these "tools" have always been available to contracting officers when subcontract prices are undefinitized. However, we feel that their use needs to be emphasized because contracting officers applied decrement factors for only 16 of the 30 sample contracts, and only 1 contract contained a reopener clause for a single subcontract. Nevertheless, prime contracts were still overpriced by $94 million.

Further, the September 20, 1989, addition of FAR 15.806-2(e), which addresses excusing contractors from submitting subcontractor cost or pricing data and the required analysis, suggests ". . . steps will be taken to protect the interest of the Government; e.g., include a contract clause that provides for negotiating an adjustment to the prime contract amount after award." Our intention in making draft report Recommendations A.1.c. and A.1.d. was to provide emphasis on possible measures to protect the interest of the Government. As such, we have combined draft Recommendation A.1.d. into Recommendation A.1.c. and have reworded Recommendation A.1. to the report. We still believe that Recommendation A.1.c. is valid and request the Assistant Secretary reconsider his position in issuing a single policy memorandum that addresses Recommendations A.1.a., A.1.b. and A.1.c.

The Assistant Secretary's response to Recommendation A.2 indicates that we have not identified a material internal control weakness because the problems identified in our report are not new and were previously known, and that policy memorandums have already been issued to deal with the problems. We disagree with the Assistant Secretary's position. Based on our previously discussed perception of the current contracting environment as related to subcontract pricing and the significance of subcontract costs, we believe that noncompliance with current policy continues and such noncompliances are material internal control weaknesses. Therefore, we request that the Assistant Secretary reconsider his position to Recommendation A.2.

Defense Contract Audit Agency. We believe that DCAA's planned action would be a step in the right direction. However, we feel that establishing thresholds at the FAR 15.806-2(a) level allows for too many unanalyzed subcontracts to remain unidentified to the Procurement Contract Officer (PCO). Further, FAR 15.806-2 also requires the prime contractor to submit subcontractor cost or pricing data as well as results of their cost analyses. DCAA's proposed guidance does not address failure to provide subcontractor cost or pricing data.

FAR 15.806-1(b) requires prime contractors who are required to submit cost or pricing data to obtain cost or pricing data for all subcontracts or purchase orders expected to exceed $100,000. FAR 15.806-1(a)(2) requires prime contractors to cost analyze and provide the results of their cost analyses as part of their own cost or pricing data submission for all items identified by FAR

15.806-1(b). During our audit, we reviewed 627 proposed noncompetitive subcontracts. Our audit disclosed that 434 subcontracts, or 69 percent, were proposed between $100,000 and $1 million. Since all the contracts in our sample were valued at or above $10 million, application of DCAA's proposed guidance would not provide comments to the PCO on a significant portion of the proposed subcontracts when DCAA audit workpapers contain the information. We believe that when all members of DoD's contract negotiation "team," which includes the PCO, the administrative contracting officer and DCAA auditors, work together, the best possible contract price will be negotiated. With subcontract costs estimated to comprise over 50 percent of today's prime contract costs, we believe that DCAA should be required to identify unanalyzed subcontract costs at the threshold established by FAR 15.806-1, i.e., estimated at or above $100,000, in its price proposal reports, rather than withhold information that should be readily available from DCAA audit workpapers. Identification of unanalyzed subcontract costs estimated at or above $100,000 will provide additional assistance to the PCO in performing his or her duties and will work to the benefit of the Government in negotiating better prices with the prime contractor. It will also assist the PCO in making an informed decision regarding the need to apply decrement factors or reopener clauses. Therefore, we believe that Recommendation A.3. is still valid as written and request that the Defense Contract Audit Agency reconsider its position in responding to the final report.

Defense Logistics Agency. DLA's planned action is responsive to the intent of the finding and recommendation.

B. Analysis of Competitive Subcontractor Proposals

FINDING

Contracting officers were not always aware of prime contractor analyses of competitive subcontract proposals. This occurred because the FAR and the DFARS do not require cost analyses of competitive subcontracts. Prime contractors also did not apply decrement factors to competitively proposed subcontracts. As a result, prime contractors' negotiated savings of $13.3 million in competitive subcontract costs were not passed on to the Government.

DISCUSSION OF DETAILS

Background. The DFARS subpart 215.806(4) states that contracting officers are responsible for determining the reasonableness of the prime contract price and the subcontract costs included in the prime contract price. Where adequate price competition exists, receipt and evaluation of cost and pricing data are not required because competition is supposed to provide the best possible price. However, in some competitive subcontracts, competition is not always effective in determining the price. In these cases, the prime contractor attempts to negotiate a lower price with the subcontractor, often after completing negotiations with the Government. Prime contractors may also obtain lower prices by asking their competing subcontractors for the best and final offers. While negotiations of subcontract prices have been traditionally associated with noncompetitive proposals, many prime contractors have now established a practice of attempting to reduce prices of competitively proposed items. In order to ensure that the Government pays a fair and reasonable price on competitive subcontracts, the contracting officer should try to protect the Government's interests when it knows that the prime contractor has a policy or practice of negotiating competitive quotes. Such measures include contract reopener clauses, decrement factors, or a delay in holding contract negotiations. (Reopener clauses and decrement factors were described in Finding A.)

Details of Audit. In our sampled contracts, we reviewed 144 competitive subcontracts, proposed at $56.5 million, which were undefinitized at the time the prime contractor and Government agreed on a fixed contract price. Based on our statistical sample, we estimate that 1,441 subcontracts, valued at $975 million, were proposed by prime contractors in FY 1987 based on undefinitized competitive quotes at the time of contract price negotiations with the Government. We compared the quoted subcontract costs proposed to the Government with actual purchase prices subsequently paid by prime contractors. Our sample showed that prime contractors subsequently realized cost savings of $802,876 by obtaining price reductions on 47 of the 144 undefinitized competitive quotes. Based on our sample, we projected that prime contractors realized price reductions on 31.4 percent of their competitively proposed subcontracts. Price

reductions were achieved by negotiating lower prices or obtaining price reductions by asking for best and final offers or changing purchase quantities or vendors. We estimate that prime contractors saved $13.3 million on fixed-price contracts of $10 million or more negotiated in FY 1987. None of these savings was passed on to the Government.

We found that 15 of the 22 prime contractors had a practice of attempting to obtain price reductions from competitive subcontractors. The various methods used, and the contractors who used them, to obtain price reductions are shown in Appendix F. Further, 3 of the 15 contractors had a written policy that required negotiating lower prices on competitive quotes and catalog prices.

Analysis and Negotiation of Competitive Quotes. Acquisition regulations do not require prime contractors to perform cost or price analysis of subcontract cost that is based on adequate price competition or established commercial catalog and market prices. Our audit disclosed that 9 prime contractors used the results of cost analyses or price analyses in attempting to negotiate lower prices on 20 competitive subcontracts with a proposed value of $9,517,722. The contractors were successful in negotiating lower prices on 16 subcontracts at net savings of $324,657. However, the Government did not benefit from the savings because the subcontracts were negotiated after the prime contractor and the Government had agreed on a firm-fixed contract price. The Government contracts with prime contractors did not include reopener clauses to allow the Government to share in the subsequent savings.

Use of Best and Final Offers. Prime contractors frequently attempted to obtain price reductions from their competitive subcontractors by asking them for best and final offers (i.e., the lowest possible price). Although subcontractors are not obligated to reduce their prices, some do so. When the prime contractor receives best and final offers at lower than previously proposed prices, after agreeing with the Government on a fixed-price contract, only the prime contractor benefits from the savings.

Our audit showed that 5 prime contractors requested best and final offers on 17 subcontracts that were proposed based on competitive quotes at the time of contract price negotiations. Although many subcontractors did not reduce their prices, when they did reduce them prime contractors realized savings. For example, on contract N00024-87-C-6052, Honeywell, Underseas Systems Division, realized a net savings of $235,549 by obtaining best and final offers from 2 subcontractors for 12 parts that were proposed to the Government based on competitive quotes totaling $3,708,319. This $235,549 savings include a 6.2-percent decrement factor applied by the contracting officer to the bill of material items for which purchase orders had not been issued. The prime contractor would have realized a $465,531 savings if the contracting officer had not applied the 6.2-percent decrement in developing a negotiating objective to protect the Government's interest. However, the

Government's interests may have been protected better by using a reopener clause when significant subcontract costs were not definitized at the time of prime contract price negotiations.

Other Contractor Savings. We found that two prime contractors obtained lower quotes from additional vendors on two subcontracts. These quotes were obtained subsequent to agreement with the Government on a firm-fixed contract price. The lower quotes resulted in a cost savings of $61,752 to the prime contractors. We also found two prime contractors that purchased larger than proposed quantities on five subcontracts and received lower unit prices. The reduction in unit prices resulted in a cost savings of $35,733 to the prime contractor. The Government did not receive any benefit in either situation.

Dual-Sourced Parts. To develop competition, to ensure product quality, and to meet delivery schedules, prime contractors often split their procurements of a particular part among two or more subcontractors. The audit disclosed that prime contractors vary in their treatment of when to perform cost or price analyses of subcontractor proposals in a dual-sourced purchase arrangement. Most contractors believe that because prices are driven by competition, a cost analysis is not required. Based on our statistical sample, we projected that prime contractors proposed $1.04 billion in subcontracted materials to be placed as dual-source procurements. This projection applied to fixed-price contracts negotiated at $10 million or more in FY 1987. From this $1.04 billion universe, we projected that $602.6 million was negotiated or definitized by the prime contractor and its subcontractor after the prime contractor and Government had agreed on a firm-fixed-price contract. The audit also showed that prime contractors realized cost savings on dual-source proposed parts by negotiating with their subcontractors or changing the percentage split among subcontractors. Since this occurred after agreement on a fixed price with the Government, only the prime contractor received the benefits. Based on our statistical sample, we estimate these savings to be $4.96 million above the Government's negotiating position. These savings were not passed on to the Government. Because prime contractors treat individual dual-source subcontractors as either noncompetitive or competitive, we have not made separate recommendations addressing dual-source subcontracted parts. We believe that the recommendations for noncompetitive and competitive proposed items made in Finding A and in this finding should correct the deficiency.

Protecting the Government's Interests. Contracting officers must try to protect the Government's interests when negotiating fixed-price contracts with prime contractors who have policies or practices of obtaining price reductions to competitive quotes or dual-sourced parts through traditional negotiations, asking for best and final offers, or other means. Identifying contractors who attempt to obtain price reductions on competitive quotes should begin with contractor and DCAA estimating system surveys. The current DCAA Audit Program for Estimating Systems Surveys, section IV.H.3.a., requires the auditor to determine whether

competitive bids are solicited to obtain effective competition. Section IV.H.3.j. states that a determination be made as to whether price reductions from vendors are considered in price estimates. DCAA preaward evaluations of prime contractor price proposals usually develop and suggest the application of a decrement factor to undefinitized quotes without distinguishing between noncompetitive and competitive items. We believe that contracting officers apply this decrement to noncompetitive quotes only, because they believe that competitively quoted items are not further reduced. Our position is supported by the findings in House Report 100-1026 as discussed in Part I of this report.

To ensure that contracting officers are aware of prime contractors who obtain price reductions on competitive quotes, the DCAA estimating system surveys should indicate whether contractors have written policies or actual practices of obtaining price reductions from competitive quotes. We believe contracting officers would then be aware of contractors' practices when reviewing the estimating systems report before developing a negotiation position, and they would be better informed on the base costs upon which to apply a decrement. When contracting officers know that a contractor has a practice of obtaining price reductions to competitive quotes and the undefinitized competitive subcontract costs are significant, contracting officers should consider delaying negotiations until major subcontracts are negotiated, using a contract reopener clause as described in Finding A, or using a decrement factor.

RECOMMENDATIONS FOR CORRECTIVE ACTIONS

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) include coverage of competitive and dual-source items in the policy memorandum issued to the Military Departments and Defense agencies in response to Recommendation 1 to Finding A. The policy memorandum should emphasize the need for contracting officers to require prime contractors to submit proposals in Federal Acquisition Regulation table 15-2 format, obtain results of prime contractor's cost analyses before negotiations, and apply decrement factors to noncompetitive, competitive, and dual-source proposed parts whenever the contractor has a history of negotiating lower prices with its subcontractors and the proposed subcontract costs are not significant. The policy memorandum should encourage the use of negotiated reopener clauses in firm-fixed-price contracts where substantial subcontract costs have not been negotiated before agreement on price, or consider delaying contract negotiations until these subcontracts have been negotiated.

2. We recommend that the Director, Defense Contract Audit Agency, expand its audit guidance for surveys of contractor estimating systems and price proposal reports to include specific identification in reports of the applicability of decrement factors to both competitive and noncompetitive quotes that remain undefinitized at the time of contract price negotiations.

MANAGEMENT COMMENTS

Assistant Secretary of Defense (Production and Logistics). The Assistant Secretary of Defense (Production and Logistics) nonconcurred with Recommendation B.1. stating that cost or pricing data are not required on competitive contracts and are obtained on dual-source contracts only when adequate price competition is lacking. The Assistant Secretary also indicated that amendments to the FAR in August 1989 and the DFARS in March and May 1989 clarified the existing coverage on adequate price competition, the role the Government and its prime contractors play in pricing of subcontracts, and the use of historical vendor pricing information. Based on recent changes to the FAR and DFARS and his response to Recommendation A.1., the Assistant Secretary believes current coverage is appropriate and further emphasis at this point is not warranted. The full text of the Assistant Secretary's comments is in Appendix J.

Defense Contract Audit Agency. The Defense Contract Audit Agency nonconcurred with Recommendation B.2. stating that it is currently providing information in relation to contractors who negotiate competitive or dual-source quotes through their use of decrement factors. A decrement factor is developed as part of DCAA's review of a contractor's estimating system. This decrement factor is used in its proposal evaluation. The decrement factor considers both competitive and noncompetitive subcontracts. Details supporting the decrement factors are presented in both estimating system survey reports and price proposal reports. The full text of the Defense Contract Audit Agency comments is in Appendix O.

AUDIT RESPOMSE TO MANAGEMEMT COMMENTS

Assistant Secretary of Defense (Production and Logistics). The Assistant Secretary's response is misleading and does not address the intent of our finding. The thrust of the Assistant Secretary's response dealt with the adequacy of competition and subcontract pricing when cost or pricing data are required. Our intent was to make contracting officers aware of contractor practices of obtaining lower than proposed prices on competitive and dual-source subcontracts and, that when these practices exist, actions need to be taken to protect the Government's interests. Traditionally, competitive and dual-source subcontracts costs have been accepted by the Government as proposed by the prime contractor, based on the belief that competition would deliver the best price. Our audit disclosed that competitive and dual-source subcontracts were accepted as proposed in negotiations with 10 of 15 prime contractors who used various practices for obtaining price reductions on competitive quotes after negotiations were completed. Only five contracting officers applied a specific decrement factor to subcontracts based on competitive quotes. Because contracting officers were unaware of contractor practices, or did not adequately protect the Government's interests, prime contractors were able to reduce proposed and accepted competitive prices by a projected $13.3 million. Amendments to the FAR and

DFARS, as well as other policy memorandums issued over the past 3 years, have not placed the proper emphasis on what we believe is a recent trend among prime contractors, i.e., obtaining price reductions on competitive or dual-sourced subcontracts. Therefore, we believe that Recommendation B.1. is still correct as written and request the Assistant Secretary to reconsider his position by responding to the final report.

Defense Contract Audit Agency. We agree with the Defense Contract Audit Agency (DCAA) comments regarding the development and presentation of decrement factor information in estimating system survey reports and price proposal reports. However, as discussed in Finding B, DCAA price proposal reports suggest the application of a decrement factor to undefinitized quotes, without distinguishing between noncompetitive and competitive items. We still believe that contracting officers apply this decrement factor only to noncompetitive quotes because they believe that competitively quoted items are not further reduced. Of the 16 contracts where the contracting officer applied a decrement factor during negotiations, only 6 contracting officers specifically applied a decrement to competitive quotes. However, prime contractors realized savings on competitive quotes for 8 of these 16 contracts. We believe that the Defense Contract Audit Agency should indicate in both their estimating system survey reports and price proposal reports that the decrement factor should be applied to undefinitized competitive and noncompetitive quotes as applicable, rather than only to "undefinitized quotes." This additional information should put contracting officers in a better position during contract price negotiations. Recommendation B.2. has been reworded for the final report and expanded to make it more specific. We request that the Defense Contract Audit Agency reconsider its position to the revised Recommendation B.2. by responding to the final report.

C. Government Assist Audits Published After Contract Price Negotiations

FINDING

The Government made audits of subcontract proposals for which it did not receive any benefits. This situation occurred because contracting officers did not always follow up with DCAA on outstanding assist audit reports before reaching the final agreement on contract price or they did not delay negotiations pending assist audit results for subcontract costs. Also, contracting officers requested, and DCAA performed, assist audits after the prime contractor and the Government agreed on a firm-fixed contract price. In these situations, contracting officers wasted DoD contract audit resources. As a result, we projected that DCAA performed 76 assist audits costing $169,742 in audit resources, which had potential benefits to the prime contractor, but the Government did not receive any benefits.

DISCUSSION OF DETAILS

Background. Assist audit reports are intended to provide the contracting officer a detailed analysis of subcontractor proposals to determine the reasonableness of the total proposed contract price, to develop prenegotiation objectives and to negotiate the contract. DFARS subpart 215.806(c)(6) provides a contract clause that may be used for subsequent redetermination of contract cost for subcontracts not negotiated when the prime contractor and the Government agreed on contract price. The use of assist audits is essential for the contracting officer to protect the Government's interest in contract negotiations.

We reviewed the use of results from the 152 assist audits performed for 30 fixed-price contracts in our statistical sample. Our sample included 19 assist audits (Appendix H) published after the prime contractor and Government had agreed on a fixed-price contract. The Government wasted DoD contract audit resources in performing these audits, and received no benefit from these 19 assist audits. However, we found that the use of results from three assist audits contributed toward a prime contractor's savings of $538,869 when compared to the Government's negotiation position. Based on our sample, we projected that the Government did not receive any benefit from 76 of the 1,140 assist audits performed by DCAA on FY 1987 fixed-price contracts of at least $10 million. However, prime contractors often used results of assist audits in their subcontract negotiations.

Assist Audits Requested Before But Published After Contract Negotiation. Our sample showed that 7 of the 19 assist audits published after contract price negotiations were requested before negotiations. These seven audits cost DCAA $15,109 to perform. Based on our statistical sample, we projected that 53 assist audits, costing DCAA $114,396 in audit resources, did not benefit the Government because the audit results were published after contract negotiations. We reviewed prenegotiation and price

negotiation memorandums and did not find any evidence of contracting officers contacting DCAA to determine the results or status of these assist audits. Discussions with contracting officers indicated that they were under time pressure to get contracts awarded and would not delay negotiations to wait for assist audit results.

Our audit disclosed that the results of four assist audits for subcontracts proposed at $4,945,213 were published within 11 days after completion of contract negotiations. However, contracting officers neither delayed contract negotiations nor contacted DCAA concerning the status of these four assist audits. We reviewed the prime contractors' subcontract cost analyses and price negotiation memorandums related to these four assist audits and determined that in two instances, prime contractors used the assist audit results in negotiating with their subcontractors. Use of the audit results contributed toward saving prime contractors $212,970 above the Government's negotiated or decremented position for the audited proposals and an additional savings of $270,760 for one prime contractor who combined buys for two production lots, for a total savings of $483,730. In another instance, the audit results of a $289,210 proposal were published 30 days after Government negotiations. The results were used by the prime contractor in negotiating with the subcontractor and contributed toward a savings of $55,139. However, these savings were not recoverable because the Government did not have any recourse in the adjustment of the prime contract price after contract award.

Assist Audits Requested and Performed After Contract Negotiation. Our sample showed that 12 of the 19 assist audits published after contract price negotiations were also requested by contracting officers after agreeing to a firm-fixed contract price. The 12 audits cost DCAA $28,876 to perform. We projected that 23 assist audits, costing DCAA $55,346 in audit resources, were requested and performed after the prime contractor and the Government agreed on a firm-fixed contract price. As a result of being requested after contract award, these assist audits did not benefit the Government in the negotiation of contract price. Further, price reductions achieved as a result of the prime contractors' use of these assist audits were not recoverable because the Government did not use a contract clause allowing for an adjustment of the prime contract price after the contract award. Because the Government could not receive any benefit on the negotiations of the immediate contracts, these assist audits amounted to "free" audit services of subcontract price proposals benefiting only the prime contractor.

Our audit disclosed that the U.S. Army Tank-Automotive Command requested 10 assist audits for contract DAAE07-86-C-A050 with AVCO Lycoming Co. after a firm-fixed contract price had been negotiated. The contracting officer's letter to the administrative contracting officer cited that the assist audits were necessary to ensure the reasonableness of the total price even though the prime contract was already awarded. The

contracting officer provided additional rationale for requesting the assist audits as follows:

> 1. In pricing the prime contract, AVCO Lycoming presumed such services would be available. No alternative methods of evaluation were discussed or priced.
>
> 2. AVCO's purchasing system policies provide for assist audits. Failure to properly analyze subcontract prices would certainly be an issue during the next purchasing system review.
>
> 3. Future spares contracts are likely to be based on contract DAAE07-86-C-A050 material prices. Pricing of such spares when a subcontract is involved may require an assist audit anyway. If the spare item is broken out to the subcontractor, DCAA will already have analyzed a larger buy for the spare part and the subcontractor will not be able to argue that the (unaudited) price with the prime contractor is the fair and reasonable price.

In our opinion, the requests for assist audits were not justified because they could not be used by the contracting officer to determine the reasonableness of the total proposed price, to develop a prenegotiation objective, or to negotiate the immediate contract. The need for, and request of, audit assistance should have occurred early in the proposal review process instead of after contract award. Further, it would be more appropriate to price future spares proposals on subcontract cost analyses performed on the most current cost and pricing data available. The Government did not receive any benefit from these 10 assist audits in the negotiation of contract DAAE07-86-C-A050 because the contract was negotiated before the contracting officer's audit requests. DCAA expended $23,815 in performing these 10 assist audits. The prime contractor used the results of at least 5 of these 10 assist audits in its subcontract negotiations.

RECOMMENDATIONS FOR CORRECTIVE ACTION

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense agencies that emphasizes to contracting officers the need to:

- Follow up with the Defense Contract Audit Agency on outstanding assist audits before prime contractor and Government agreement on final contract price occurs, or

- Use a contract reopener clause for subsequent redetermination of subcontract costs for significant subcontracts not negotiated at the time the prime contractor and the Government agree on contract price when it is known that an assist audit is in progress or will be requested, or delay negotiations pending assist audit results.

2. We recommend that the Commander, U.S. Army Tank-Automotive Command, issue policy guidance to its contracting officers that ensures:

a. Requests for assist audits of subcontractor price proposals are made sufficiently in advance of price negotiations so that results may be used in developing negotiation objectives.

b. Any requests for assist audits after price negotiations on firm-fixed-price contracts are only made if there will be a potential direct monetary benefit (i.e., price reduction) to the Government on the immediate contract.

MANAGEMENT COMMENTS

Assistant Secretary of Defense (Production and Logistics). The Assistant Secretary of Defense (Production and Logistics) partially concurred with Recommendation C.1. stating that he would issue a policy memorandum that emphasizes follow up with DCAA on outstanding assist audits before agreement on final price. The full text of the Assistant Secretary's comments is in Appendix J.

Army. The Army nonconcurred with Finding C, stating it disagreed with the audit conclusion that the Government did not receive any benefits from assist audits performed after the prime contractor and the Government agreed on a firm-fixed contract price. The Army further stated that:

> In negotiating firm-fixed price contracts, the U.S. Army Tank-Automotive Command generally agrees to provide assist audits, as necessary, for the prime contractor in exchange for a decrement factor on the contract price. In effect, the Government receives its monetary benefits for assist audits in the form of reduced prices at the time the contract is awarded.

However, the Army concurred with Recommendation C.2.a. and indicated concurrence with Recommendation C.2.b. Regarding Recommendation C.2.a., management indicated that policy guidance would be issued by January 31, 1990. In response to Recommendation C.2.b., management indicated that policy guidance would be issued by January 31, 1990,

> . . . with the stipulation that requests for assist audits after contract award on firm-fixed price contracts will be made only if (i) it is believed that the assist audits will result in a potential direct monetary benefit to the Government on the immediate contract, or (ii) they can be directly linked to decrement factors which were agreed to by the prime contractor during contract negotiations.

The full text of the Army's response is shown in Appendix L.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

Assistant Secretary of Defense (Production and Logistics). The Assistant Secretary's planned action in response to Recommendation C.1. was responsive to the intent of the finding and recommendation. For this report, we merged draft report Recommendations D.1.a., D.1.b., and D.1.c. into Recommendation C.1. to improve readability. Because the Assistant Secretary did not provide an estimated completion date for Recommendation C.1., we are asking that he do so in response to the final report.

The Comptroller of the DoD, although not specifically requested, fully concurred with Recommendations C.1.a. Refer to Appendix K for the Comptroller's complete comments.

Army. The Army's basis for nonconcurring with the audit finding is unsupportable. Specifically, we reviewed the Army's Business Clearance Review for the AGT1500 Engine Multiyear Procurement and the Price Negotiation Memorandum for contract DAAE07-86-C-A050, modification PZ0009. We could not find any indication that the negotiated decrement factor was in any way related to the continuation of audit assistance after price finalization. Further, during our exit brief, contracting personnel at the U.S. Army Tank-Automotive Command indicated that they directed the continuation of audit assistance in order to help the prime contractor maintain an approved purchasing system.

In general, the negotiation of a decrement is part of the normal negotiation process. The Defense Contract Audit Agency will routinely recommend in its preaward audit, and the contracting officer will routinely attempt to negotiate, decrements for significant proposed subcontract costs which are undefinitized at the time that the prime contractor and Government agree on a firm-fixed contract price. Decrements are based on historical data which show that the contractor, as a matter of business, is able to negotiate prices with its subcontractor that are lower than proposed and are not tied to audit support. Therefore, we believe that the audit finding is valid as written and request that the Army reconsider its position in response to the final audit report.

The Army's response to Recommendation C.2.b. is a partial concurrence because the Army's stipulation to directly link post-award assist audit requests to agreed upon decrement factors does

not comply with the intent of the recommendation. We believe that contracting officers have been able to negotiate adequate decrements without providing for postaward audit assistance and that the Army's "linking" stipulation will only increase requests for DoD's limited audit resources, without providing an additional monetary return. Also, we doubt that the Defense Contract Audit Agency would perform such audits if they knew that a firm-fixed contract price had been finalized, unless the contract contained "reopener" clauses for a specific subcontract. The Comptroller of the Department of Defense shares our concerns regarding the use of DoD's limited audit resources (see Appendix K for comments from the Comptroller, DoD). Therefore, we request that the Army reconsider its position and delete any requirement to link post-award assist audit requests to negotiated decrement factors, when issuing guidance in response to Recommendation C.2.

D. Potential Defective Pricing of Nine Contracts

FINDING

Nine contractors potentially violated the provisions of the Truth in Negotiations Act, as amended (formerly codified at 10 U.S.C., title 10, section 2306(f)), by not providing accurate, complete, and current cost or pricing data in support of their subcontract costs. These nine contractors did not provide the Government negotiator with the most current quotes available, did not update proposals to reflect subcontract prices negotiated before agreement on prime contract price, or did not disclose results of their cost analyses and negotiation targets for undefinitized subcontracts developed before agreement on contract price. As a result, these nine contracts were potentially defectively priced by $1.47 million. All potential defective pricing has been referred to cognizant DCAA offices and will be incorporated into their comprehensive defective pricing reviews.

DISCUSSION OF DETAILS

Background. The Truth in Negotiations Act, as amended, is intended to avoid contract overpricing by ensuring that the Government and contractor have equal knowledge of facts (informational parity) affecting contract pricing. Informational parity is achieved by requiring Government contractors to certify that their cost or pricing data are accurate, complete, and current at the time of agreement on contract price. The Truth in Negotiations Act also requires a downward price adjustment if a negotiated price is overstated because a contractor furnished inaccurate, incomplete, or noncurrent pricing data to the Government.

Details of the Audit. An audit of the prime contractor's proposed bills of material, accounting records, and the Government's negotiation memorandums for the 30 sampled contract actions disclosed that 9 contractors (Appendix H) potentially violated the Truth in Negotiations Act, as amended, by not providing the Government negotiators with accurate, complete, and current cost or pricing data for subcontracted items. We reviewed available data for 949 items proposed at $100,000 or more. The review disclosed that 35 items on 9 contracts were potentially defectively priced by a total of $1,471,202. The potential defective pricing occurred because contractors did not provide the Government negotiator with the most current quotes available before negotiations, the subcontract prices were negotiated before prime contract negotiations at prices lower than proposed, and the results of their cost analyses and negotiation targets for undefinitized subcontracts developed before prime contract negotiations.

We did not perform a complete review of all material or other cost elements proposed by these contractors because this was outside the scope of our audit. All potential defective pricing has been referred to cognizant DCAA offices, who have agreed to incorporate

our results into their comprehensive defective pricing reviews. A complete review of all cost elements may disclose additional defective pricing or offsets to defective pricing.

RECOMMENDATIONS FOR CORRECTIVE ACTION

1. We recommend that the Assistant Secretary of the Navy (Shipbuilding and Logistics):

a. Request the cognizant procurement contracting officers to monitor the progress of the responsible Defense Contract Audit Agency offices that have agreed to perform comprehensive defective pricing reviews on the following contracts, based on our referral of potential defective pricing of $1,147,229.

Contract	Potential Defective Amount
N00019-86-C-0326	$ 686,303
N00019-87-C-0052	33,454
N00024-86-C-5212	184,250
N00024-87-C-6318	17,098
N00024-87-C-6066	138,107
N00039-87-C-0088	88,017
	$1,147,229

b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended.

2. We recommend that the Assistant Secretary of the Air Force (Acquisition):

a. Request the cognizant procurement contracting officer to monitor the progress of the responsible Defense Contract Audit Agency office that has agreed to perform comprehensive defective pricing reviews based on our referral of potential defective pricing of $244,009 on the following contracts.

Contract	Potential Defective Amount
F33657-86-C-0068	$104,758
F34601-87-C-2269	139,251
	$244,009

b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended.

3. We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition):

a. Request the cognizant procurement contracting officer at the U.S. Army Missile Command to monitor the progress of the responsible Defense Contract Audit Agency office that has agreed to perform a comprehensive defective pricing review based on our referral of potential defective pricing of $79,964 on Contract Number DAAH01-87-C-0220.

b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended.

MANAGEMENT COMMENTS

Navy. The Navy nonconcurred with Recommendation D.1.a. stating that "it is not appropriate nor is there time for Navy contracting officers to monitor DCAA auditors. If DCAA believes there is defective pricing, they will notify us and at that time we will take appropriate action." The Navy concurred with draft Recommendation D.1.b. Refer to Appendix M for the Navy's complete comments.

Air Force. The Air Force concurred with Recommendation D.2. stating it has requested the cognizant PCO to take action as necessary to follow up on the defective pricing audits. Refer to Appendix N for the Air Force's complete comments.

Army. The Army concurred with Recommendation D.3. and stated that it is waiting for the Defense Contract Audit Agency to complete its defective pricing review. The Army indicated that it would negotiate and recover any funds due the Government upon receipt of the Defense Contract Audit Agency report. The Army established a target completion date of March 31, 1990. Refer to Appendix L for the Army's complete comments.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

The Army and Air Force planned actions are responsive to the finding and recommendation.

Although the Navy nonconcurred with Recommendation D.1.a., it indicated that it would take appropriate action when notified by DCAA that defective pricing had occurred. As such, we feel that the Navy's planned action is responsive with the intent of our finding and recommendation.

SCHEDULE OF SAMPLED CONTRACTS

Strata	Contractor	Contract Number	Value of Contract Action 1/	Negotiated Contract Value 2/	Net Savings 3/ <Loss>
			(in Thousands)		
1	Honeywell, Inc., Armament Systems Div.	DAAA09-87-C-1122	$ 19,350	$ 25,800	$ 0
1	Cummins Engine Co.	DAAE07-87-C-A001	33,519	33,519	0
1	LTV Aerospace and Defense Co.	DAAH01-87-C-0220-0005	43,117	44,129	2
1	Boeing Military Airplane Co.	F34601-87-C-1390	14,545	45,500	219
1	Cubic Corporation	N00019-87-C-0052	12,952	12,952	37
1	General Electric Co., NDTSD	N00024-87-C-4279	20,640	20,640	61
1	UNISYS	N00024-87-C-5351	35,220	35,220	0
1	UNISYS	N00024-87-C-5351-P0003	14,000	14,000	197
1	Hughes Aircraft Co.	N00024-87-C-6066	22,105	22,105	69
1	Goodyear Aerospace Corp.	N00024-87-C-6318	33,000	33,000	<355>
1	Rockwell International, ASMD	N00039-87-C-0088	11,271	17,665	<31>
1	Rockwell-Marconi JVT	N00039-87-C-0282	14,017	42,260	3,917
2	Ford Aerospace and Communication Corp.	DAAB07-86-C-E019-0002	50,570	103,581	<94>
2	General Electric Co., OSD	DAAE07-86-C-A023	59,551	62,817	150
2	Raytheon Company, MSD	DAAH01-86-C-0262-0057	82,521	82,521	758
2	Hughes Aircraft Company	DAAJ09-87-C-A095	67,000	67,000	877
2	Raytheon Company, MSD	F08635-87-C-0065-1/2/3	66,800	156,438	185
2	Grumman Aerospace Corp.	N00019-86-C-0096-0007	66,875	213,600	<998>
2	Motorola, Inc. (GEG)	N00024-87-C-5310	51,481	59,811	50
2	Hughes Aircraft Co.	N00039-87-C-0211	81,172	81,172	0
3	Textron Lycoming	DAAE07-86-C-A050 4/	470,922	1,047,081	583
3	Detroit Diesel Allison Division, GMC	DAAE07-87-C-A010	115,371	115,289	14
3	Loral Electronics Systems	F33657-86-C-0068	104,800	126,000	387
3	Lockheed Corp.	F33657-86-C-2000	162,400	820,400	<15>
3	Boeing Military Airplane Co.	F34601-87-C-2269	164,216	164,216	738
3	International Business Machines Corp.	N00024-86-C-5212	116,223	205,250	217
3	Morton-Thiokol, Inc.	N00024-87-C-5331	162,495	162,495	2,022
3	Honeywell, Inc., Undersea Systems Div.	N00024-87-C-6052	136,520	399,000	1,495
4	McDonnell Douglas Helicopter Co.	DAAJ09-87-C-A009	1,143,577	1,143,577	2,688
4	Texas Instruments, Inc.	N00019-86-C-0326	515,779	515,779	2,948
	Total		$3,892,009	$5,872,817	$16,121

Footnotes are on the next page.

1/ This column represents the values from which the sample selection and stratification were based as identified in the Individual Contract Action Report (DD Form 350) at yearend FY 1987. Appendix B explains the sample methodology.

2/ This column represents the negotiated value of the contract action upon which the audit was performed.

3/ This column indicates the net savings or <loss> realized by the prime contractor through negotiations with its subcontractors subsequent to agreement on a fixed-price contract with the Government. The savings or <loss> considers the Government's negotiating objectives, including decrements applied by the contracting officer, and is the sum of all savings or losses for noncompetitive, competitive and dual-source items proposed at or above $100,000 per item. See page 2 of this audit report for additional details on the audit scope.

4/ Value of contract action DAAE07-86-C-A050 includes modifications PZ0009, P00011, P00015 and P00020.

SAMPLE METHODOLOGY

A stratified random sample was used for this audit to reduce the expected high level of variation. The scope of this audit was FY's 1986 and 1987 fixed-price contract actions negotiated during FY 1987 with a minimum value of $10 million. The DD350 data base was used to determine the universe, which was divided into four strata. A total of 30 pricing actions were reviewed within the four strata to obtain a 90-percent confidence level with a precision of +/- 15 percent on the dollar projection. The four strata were divided and the sample was selected as follows:

		Universe		Sample	
Strata		Actions	Dollars (billions)	Actions	Dollars (billions)
Stratum I	$10-50 MIL	408	$ 8.513	12	$ 0.294
Stratum II	$50-100 MIL	41	2.814	8	.526
Stratum III	$100-500 MIL	29	4.885	8	1.413
Stratum IV	$Over 500 MIL	3	2.530	2	1.659
Total		481	$18.742	30	$ 3.892

The DD350 universe had to be adjusted for actions that either were misclassified or represented advanced long-lead funding actions that had not been given a final price. This adjustment reduced the projectable universe to the following:

		Universe	
Strata		Actions	Dollars (billions)
Stratum I	$10-50 MIL	175	$ 4.207
Stratum II	$50-100 MIL	27	1.871
Stratum III	$100-500 MIL	21	3.913
Stratum IV	$Over $500 MIL	2	1.659
Total		225	$11.650

SCHEDULE OF FEDERAL ACQUISITION REGULATION REQUIRED SUPPORTING DATA FREQUENTLY OMITTED FROM CONTRACTORS' PRICE PROPOSALS

Contractor	Contract Number	Type of Subcontract	Degree of Competition	Basis For Establishing Source	Reasonableness of Price	Results of Prime's Cost Analysis
Honeywell, Inc., Armament Systems Div.	DAAA09-87-C-1122	No	No	Yes	No	No
Cummins Engine Co.	DAAE07-87-C-A001	No	No	No	No	No
LTV Aerospace and Defense Co.	DAAH01-87-C-0220-0005	No	Yes	Yes	No	No
Boeing Military Airplane Co.	F34601-87-C-1390	No	No	No	No	No
Cubic Corporation	N00019-87-C-0052	No	No	No	No	No
General Electric Co., NDTS Div.	N00024-87-C-4279	No	No	No	No	No
UNISYS	N00024-87-C-5351	No	No	No	No	No
UNISYS	N00024-87-C-5351-P0003	No	No	No	No	No
Hughes Aircraft Co.	N00024-87-C-6066	No	No	No	Yes	No
Goodyear Aerospace Corp.	N00024-87-C-6318	No	Yes	Yes	No	No
Rockwell International	N00039-87-C-0088	No	No	No	No	No
Rockwell-Marconi JVT	N00039-87-C-0282	Yes 1/	No	No	No	No
Ford Aerospace & Communication Corp.	DAAB07-86-C-E019-0002	No	No	No	No	No
General Electric Co., Ordnance Sys Div	DAAE07-86-C-A023	No	No	No	No	No
Raytheon Co., Missile Systems Div.	DAAH01-86-C-0262-0057	No	No	No	Yes	No
Hughes Aircraft Company	DAAJ09-87-C-A095	Yes	Yes	Yes	Yes	No
Raytheon Co., Missile Systems Div.	F08635-87-C-0065-1/2/3	No	No	No	No	No
Grumman Aerospace Corp.	N00019-86-C-0096-0007	No	No	No	No	No
Motorola, Inc. (GEG)	N00024-87-C-5310	No	No	No	No	No
Hughes Aircraft Co.	N00039-87-C-0211	No	No	No	No	No
Textron Lycoming	DAAE07-86-C-A0550-009/015	No	No	No	No	No
Detroit Diesel Allison Div., GMC	DAAE07-87-C-A010	No	No	No	Yes	No
Loral Electronics Systems	F33657-86-C-0068	Yes	Yes	No	No	No
Lockheed Corp.	F33657-86-C-2000	No	No	No	No	No
Boeing Military Airplane Co.	F34601-87-C-2269	No	No	No	No	No
International Business Machines Corp.	N00024-86-C-5212	2/	2/	2/	2/	2/
Morton-Thiokol, Inc.	N00024-87-C-5331	No	No	No	No	No
Honeywell, Inc., Undersea Systems Div.	N00024-87-C-6052	No	No	No	No	No
McDonnell Douglas Helicopter Co.	DAAJ09-87-C-A009	No	No	No	Yes	No
Texas Instruments, Inc.	N00019-86-C-0326	No	No	No	No	No
Total (when information was available)		3	4	4	5	0

1/ Yes indicates that element was included on Bill of Material.

2/ Contractor did not provide a Bill of Material.

SCHEDULE OF CONTRACTS WITH UNANALYZED SUBCONTRACT PROPOSALS AT TIME OF FIELD PRICING REPORT

Contractor	Contract Number	Did Field Pricing Report Reference Unanalyzed Subcontract Proposals?
Boeing Military Airplane Co.	F34601-87-C-1390	Yes
Cubic Corporation	N00019-87-C-0052	No
UNISYS	N00024-87-C-5351	Yes
UNISYS	N00024-87-C-5351-P0003	Yes
Hughes Aircraft Co.	N00024-87-C-6066	No
General Electric Co., OSD	DAAE07-86-C-A023	Yes
Raytheon Co., Missile Sys. Div.	DAAH01-86-C-0262-0057	No
Hughes Aircraft Company	DAAJ09-87-C-A095	No
Raytheon Co., Missile Sys. Div.	F08635-87-C-0065-1/2/3	Yes
Grumman Aerospace Corp.	N00019-86-C-0096-0007	Yes
Motorola, Inc.-GEG	N00024-87-C-5310	No
Textron Lycoming	DAAE07-86-C-A050-009/015	No
Detroit Diesel Allison Div., GMC	DAAE07-87-C-A010	No
Loral Electronics Systems	F33657-86-C-0068	No
Lockheed Corp.	F33657-86-C-2000	Yes
International Business Machines Corp.	N00024-86-C-5212	No
Morton-Thiokol, Inc.	N00024-87-C-5331	No
Honeywell, Inc., Underseas Sys. Div.	N00024-87-C-6052	No
McDonnell Douglas Helicopter Co.	DAAJ09-87-C-A009	Yes
Texas Instruments, Inc.	N00019-86-C-0326	No

DEFENSE LOGISTICS AGENCY CONTRACT ADMINISTRATION OFFICES VISITED

Contractor	Contract No.	Preanalysis Meeting	Administrating Office *
Rockwell-Marconi JVT	N00039-87-C-0282	Yes	DCASPRO R.I.
Cubic Corp.	N00019-87-C-0052	No	DCASR Los Angeles
Cummins Engine Co.	DAAE07-87-C-A001	No	DCASMA Indianapolis
General Electric Co.	N00024-87-C-4279	No	DCASPRO GE
Goodyear Aerospace Corp.	N00024-87-C-6318	Yes	DCASPRO Loral
Honeywell, Inc., ASD	DAAA09-87-C-1122	Yes	DCASPRO Honeywell
Hughes Aircraft Co.	N00024-87-C-6066	No	DCASPRO Hughes
Ford Aerospace and Communication Corp.	DAAB07-86-C-E019-002	No	DCASMA Denver
Hughes Aircraft Co.	N00039-87-C-0211	No	DCASPRO Hughes
Motorola, Inc.-GEG	N00024-87-C-5310	No	DCASMA Phoenix
Raytheon Co., MSD	DAAH01-86-C-0262-0057	No	DCASR Boston
Raytheon Co., MSD	F08635-87-C-0065-1/2/3	No	DCASPRO Raytheon
IBM Corp.	N00024-86-C-5212	No	DCASPRO IBM
Loral Electronics Systems	F33657-86-C-0068	No	DCASPRO Loral
Textron Lycoming	DAAE07-86-C-A050	Yes	DCASPRO Textron
Detroit Diesel Allison Div.	DAAE07-86-C-A010	No	DCASPRO Allison
Honeywell, Inc., USD	N00024-87-C-6052	Yes	DCASPRO Honeywell
Texas Instruments, Inc.	N00019-86-C-0326	Yes	DCASPRO T.I.

* DCASPRO - Defense Contract Administration Services (DCAS) Plant Representative Office
DCASR - DCAS Region
DCASMA - DCAS Management Area

SCHEDULE OF CONTRACTORS ATTEMPTING TO OBTAIN PRICE REDUCTIONS ON COMPETITIVE QUOTES

	Asked For Best and Final Offer	Negotiated With Subcontractor After Performing Cost/Price Analysis	Selected New, Lower Priced Vendor	Increased Quantities
Detroit Diesel Allison Div., General Motors Corp.			X	X
Ford Aerospace and Communications Corp.		X		
General Electric Co., Ordnance Systems Div.		X		
General Electric Co., Naval Drive Turbine Systems Div.	X			X
Goodyear Aerospace Corp.		X		
Grumman Aerospace Corp.		X	X	
Honeywell, Inc., Undersea Systems Div.	X			
Loral Electronics Systems		X		
LTV Aerospace & Defense Co.		X		
McDonnell Douglas Helicopter Co.		X		
Raytheon Co., Missile Systems Div.	X			
Rockwell International, ASMD	X			
Texas Instruments, Inc.	X			
Textron Lycoming		X		
UNISYS		X		

ASSIST AUDITS PUBLISHED AFTER CONTRACT NEGOTIATIONS

A. Assist Audits Requested Before, But Not Published Until After Prime Contract Award

Report Number	Report Date	Prime Contract Number	Prime Contract Negotiation Date	Audit Request Date
12517L210063-7-312	11/25/86	DAAJ09-87-C-A009	11/14/86	09/03/86
21807E210057-0437	02/17/87	DAAJ09-87-C-A009	11/14/86	02/16/86
22017A210.028	11/24/86	DAAJ09-87-C-A009	11/14/86	09/29/86
31017C210166	05/12/87	DAAE07-86-C-A050	03/25/87	12/11/86
16718B210015	10/19/87	N00024-87-C-5331	09/17/87	09/17/87
31217B210061	02/26/87	DAAE07-87-C-A010	02/18/87	10/31/86
4181-8D210013	08/12/87	F08635-87-C-0065-P002	08/13/87 1/	07/02/87

B. Assist Audits Requested and Published After Prime Contract Award

Report Number	Report Date	Prime Contract Number	Prime Contract Negotiation Date	Audit Request Date
6261-7H210.062	08/03/87	DAAE07-86-C-A050	03/25/87	05/05/87
3101-8C210073	10/27/87	DAAE07-86-C-A050	03/25/87	08/24/87
11018J2100678678	08/05/88	DAAE07-86-C-A050	03/25/87	04/23/88
11018C2101498561	05/24/88	DAAE07-86-C-A050	03/25/87	02/03/88
22608F210078-1	08/12/88	DAAE07-86-C-A050	03/25/87	06/30/88
6141-7C210033	07/01/87	DAAE07-86-C-A050	03/25/87	05/22/87
7261-8P210257	08/02/88	DAAE07-86-C-A050	03/25/87	06/28/88
7261-8P210017	09/11/87	DAAE07-86-C-A050	03/25/87	07/10/87
2211-7C2106608019	07/16/87	DAAE07-86-C-A050	03/25/87	05/29/87
2120-7B2103877975	06/02/87	DAAE07-86-C-A050	03/25/87	02/23/87 2/
6241-8J210026269	01/28/88	N00024-87-C-6318	10/28/86	12/23/87
3541-8A210036	03/31/88	DAAH01-86-C-0262	06/29/87	01/14/88

Footnotes are on the next page.

1/ Negotiations were conducted at Eglin AFB between April 13, 1987, and July 17, 1987, and were continued by telephone between July 20, 1987, and August 13, 1987; as such, we considered the audit results as being received after negotiations.

2/ Although this audit was actually requested before negotiations, we considered the request to be after negotiations because the contracting officer agreed to extend the report due date from 03/31/87 to 05/26/87. The contracting officer directed the administrative contracting officer to continue providing assist audit services even though the prime contract had been awarded. We took exception with the contracting officer's direction. Additional comments are in Finding D.

SCHEDULE OF CONTRACTS WITH POTENTIAL DEFECTIVE PRICING

Contract Number	Contractor	Potential Defective Pricing
N00024-87-C-6066	Hughes Aircraft Company	$138,107
N00019-86-C-0326	Texas Instruments, Inc.	686,303
F33657-86-C-0068	LORAL Electronics Systems	104,758
F34601-87-C-2269	Boeing Military Airplane Co.	139,251
N00019-87-C-0052	CUBIC Corporation	33,454
N00039-87-C-0088	Rockwell International	88,017
N00024-87-C-6318	LORAL (formerly Goodyear Aerospace Corporation)	17,098
N00024-86-C-5212	International Business Machines Corporation	184,250
DAAH01-87-C-0220	LTV Aerospace and Defense Company	79,964
		$1,471,202

POTENTIAL MONETARY SAVINGS AND OTHER BENEFITS

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
ALL	Compliance with regulations, Internal Control and Economy and Efficiency	*

* This report contains undeterminable monetary benefits. Our audit projections for FY 1987 were based on various procurements from a number of buying commands within the three Military Departments. The contracts included single-year and multiyear procurements, of which some contained options. As such, we were unable to project monetary benefits as any prospective cost avoidance would be based on undeterminable future requirements. Also, any defective pricing that results from this audit will be reported by the Defense Contract Audit Agency where the potential defective pricing was referred for complete review.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C 20301-8000

December 6, 1989

PRODUCTION AND
LOGISTICS
(P)CPF

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
ATTN: ACTING DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE

SUBJECT: Draft Report on Audit of Evaluation of Subcontract Price Proposals, Project No. 8CE-0001

This is in response to your October 5, 1989, request for our comments on the subject draft audit report. Our detailed responses to the report recommendations are attached.

As pointed out in your report, the auditors reviewed 30 fixed-price contract actions negotiated during fiscal year 1987 with a negotiated value of $5.8 billion. The review disclosed that procurement officials in some cases were not requiring prime contractors to submit the results of their subcontract cost analyses before negotiating contract price, and thus the government did not receive the benefits from prime contractor analyses of subcontractor proposals. However, we have already emphasized to contracting officers the need to require prime contractor submission of analyses of subcontractor proposals.

Compliance with the Truth in Negotiations Act has received significantly increased attention and emphasis within the Department over the past few years resulting in numerous policy memoranda and regulatory and statutory changes. Congressional attention has been focused on this subject and a series of Defense Contract Audit Agency (DCAA), General Accounting Office (GAO), and IG reviews have taken place. However, the subject audit performed by the IG was based on contract actions occurring during fiscal year 1987; thus, the results of the many corrective actions that have been taken would not yet be reflected in the contracts audited by the IG.

The most significant action taken by the Department to ensure that contractor proposals include all the information necessary to establish a fair and reasonable contract price was the issuance in February 1988 of additional requirements with which contractor estimating systems must comply. Contractors are now required to have estimating systems that consistently produce well-supported and documented proposals that are

acceptable as a basis for negotiation of fair and reasonable prices. The Department, at the urging of the GAO and the House Government Operations Committee, also published a list of the characteristics of an adequate estimating system and required that an estimating system review be performed by DCAA at a contractor location at least every three years. An adequate estimating system must provide for the use of historical experience, including historical vendor pricing information where appropriate. One indicator of significant estimating deficiencies is a continuing failure to analyze material costs or failure to perform subcontractor cost reviews as required. We are firmly convinced that good estimating systems are the key to the establishment of fair and reasonable prices.

In summary, instead of pursuing endless solutions to the problems identified by the IG, the significant actions already taken should be given adequate time to produce results. The Services, Defense Logistics Agency, and DCAA continue to devote significant effort and resources to ensuring that contractors comply with statutory and regulatory requirements in this area.

Based on the current extensive emphasis placed on subcontract price proposals, and the fact that this audit covered awards made during fiscal year 1987, we believe additional guidance to contracting officers is not warranted.

Jack Katzen
Assistant Secretary of Defense
(Production and Logistics)

Attachment

IG DRAFT REPORT - AUDIT OF THE EVALUATION OF SUBCONTRACT PRICE PROPOSALS (PROJECT NO. 8CE-0001) DATED OCTOBER 5, 1989

ASD(P&L) RESPONSE TO THE DRAFT REPORT

RECOMMENDATION A.1.a.: That the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to Military Departments and Defense agencies emphasizing the need for contracting officers to require prime contractors to submit proposals in Federal Acquisition Regulation Table 15-2 format.

ASD(P&L) RESPONSE: Nonconcur. Federal Acquisition Circular (FAC) 84-51, published August 21, 1989, revised Table 15-2 to clarify the types of information prime contractors must submit. We see no need for a policy memorandum in view of this recent revision.

RECOMMENDATION A.1.b.: That the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to Military Departments and Defense agencies emphasizing the need for contracting officers to obtain results of prime contractors' cost analyses before negotiations.

ASD(P&L) RESPONSE: Nonconcur. Policy memoranda issued November 22, 1985, and April 6, 1987, restated the Federal Acquisition Requirement (FAR) requirement that contracting officers obtain prime contractor analyses of subcontractor cost or pricing data so that it may be effectively utilized during prime contract negotiations. The second memorandum also stressed that subcontract costs comprise a substantial portion of the total cost of a contract and should be the subject of increased management attention during both contract clearance reviews and procurement management surveys. In addition, both the FAR and the DoD Federal Acquisition Regulation Supplement (DFARS) were recently revised to clarify and amplify guidance related to the pricing of subcontracts. As a result of increased management concern over subcontract pricing, FAR 15.804-6, 15.805-5, and Table 15-2 in 15.804-6 were amended, and 15.806-1 through 15.806-3 were added to clarify the roles that the government and its prime contractors play in the pricing of subcontracts, to provide guidance on various aspects of subcontract pricing, to consolidate requirements for ease of use, and to ensure that the government pays fair and reasonable prices for its needs. The FAR clearly states that contractors must submit the results of all subcontract reviews and evaluations as part of their own cost or pricing data submissions in accordance with 15.805-5(i-k). DFARS 215.811-77 cites failure to perform subcontractor cost reviews required by FAR 15.806 as an indication of an estimating system deficiency. We believe this recent emphasis on

subcontract pricing is sufficient and further emphasis at this point is not warranted.

RECOMMENDATION A.1.c.: That the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to Military Departments and Defense agencies emphasizing the need for contracting officers to require prime contractors to apply decrement factors to the proposed price of undefinitized, noncompetitive proposed parts that are not significant.

ASD(P&L) RESPONSE: Nonconcur. Our regulations require that subcontractors provide cost or pricing data to the prime contractor and that the prime contractor perform an adequate evaluation of such data. Decrement factors are an additional tool for evaluating prime contractor submissions. In reports 87-140 and 89-68, the General Accounting Office (GAO) recommended the use of decrement factors and analysis of variances when performing cost analysis on material costs based on quotes or estimates. Based on the GAO's recommendation, our April 7, 1987, policy memorandum stated that contracting officers should insist on receiving information on decrement factors along with other cost or pricing data submitted by contractors. We believe current coverage appropriately emphasizes the use of decrement factors and further emphasis at this point is not warranted.

RECOMMENDATION A.1.d.: That the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to Military Departments and Defense agencies emphasizing the need for contracting officers to require prime contractors to use negotiated reopener clauses in firm-fixed-price contracts when substantial subcontract costs have not been negotiated before agreement on price or delay contract negotiations until these subcontracts have been negotiated.

ASD(P&L) RESPONSE: Nonconcur. The practical effect of this recommendation would be either significant delays in the negotiation of firm-fixed-price contracts or inclusion of reopener clauses in every firm-fixed-price contract which would effectively eliminate firm-fixed-price contracts. Firm-fixed-price contracts provide for a price that is not subject to any adjustment. This contract type places maximum risk and full responsibility for all costs and resulting profit or loss on the contractor. It provides maximum incentive for the contractor to control costs and perform effectively and imposes a minimum administrative burden upon the contracting parties. We are concerned that reopener clauses will not protect the government's interests. Instead, we will shift risk from the contractor to DoD and disincentivize prime contractors from obtaining the best possible subcontract prices. In addition, the administrative burden to renegotiate every contract with a reopener clause would be excessive.

RECOMMENDATION A.2.: That the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in Recommendation A.1., as material internal control weaknesses using procedures established in DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

ASD(P&L) RESPONSE: Nonconcur. We do not believe the IG has identified a material internal control weakness. The problems identified are not new; they have been the subject of previous GAO reports and Congressional hearings during 1987 and 1988. Regulations have already been revised and policy memoranda have already been issued to deal with the problems identified. Had the office of the IG focused its review on more recent contract actions, we believe the results would have been significantly different because of the increased emphasis that has been placed on these issues during the past three years.

RECOMMENDATION B.1.: That the Assistant Secretary of Defense (Production and Logistics) include coverage of competitive and dual-source items in its policy memorandum issued to the Military Departments and Defense agencies in response to Recommendation A.1. The policy memorandum should emphasize the need for contracting officers to require prime contractors to submit proposals in Federal Acquisition Regulation Table 15-2 format, obtain results of prime contractor's cost analyses before negotiations, and apply decrement factors to noncompetitive, competitive, and dual-source proposed parts whenever the contractor has a history of negotiating lower prices with its subcontractors and the proposed subcontract costs are not significant, or use negotiated reopener clauses in firm-fixed-price contracts where substantial subcontract costs have not been negotiated before agreement on price, or delay contract negotiations until these subcontracts have been negotiated.

ASD(P&L) RESPONSE: Nonconcur. Cost or pricing data are not obtained on competitive contracts and are obtained on dual-source contracts only when adequate price competition is lacking. Defense Acquisition Circular (DAC) 88-6, published March 31, 1989, amended DFARS 215.6 and 215.8 to clarify the existing coverage on adequate price competition and specifically addressed the issue of dual sourcing. As a result of increased management concern over subcontract pricing FAC 84-51, was published August 21, 1989, to amend the FAR and clarify the roles the government and its prime contractors play in pricing of subcontracts, to provide guidance on certain aspects of subcontract pricing, and to ensure the government pays fair and reasonable prices for its needs. DAC 88-7, published May 31, 1989, amended the DFARS to clarify that historical experience includes historical vendor pricing information. Based on the above and our response to Recommendation A.1, we believe current coverage is appropriate and further emphasis at this point is not warranted.

RECOMMENDATION B.2.: That the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in Recommendation B.1., as material internal control weaknesses using procedures established in DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. Deleted

ASD(P&L) RESPONSE: Nonconcur. See response to Recommendation A.2.

RECOMMENDATION C.1.: That the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense agencies that emphasizes to contracting officers the need to use assist audit results in developing negotiation positions and to document the use of assist audit results in the price negotiation memorandum. Deleted

ASD(P&L) RESPONSE: Nonconcur. Policy memoranda issued February 11, 1987, May 14, 1987, and December 12, 1988, instructed contracting officers to exercise greater diligence in establishing and documenting price negotiation objectives, and in requesting and using audit findings during contract negotiations. In addition, FAR 15.808(a)(8) specifies that the price negotiation memorandum must contain the field pricing report recommendations and the reasons for any pertinent variances. In addition, timeliness is a very important factor in the use of assist audit results. As a result of an IG review of the timing of the procurement offices' requests for audit and use of audit reports, a policy memorandum was issued on January 13, 1989, emphasizing the need for increased coordination in establishing proposal audit report due dates.

RECOMMENDATION C.2.: That the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in Recommendation A.1., as material internal control weaknesses using procedures established in DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. Delet

ASD(P&L) RESPONSE: Nonconcur. See response to Recommendation A.2.

RECOMMENDATION D.1.: That the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense agencies that emphasizes to contracting officers the need to: C.

a. Follow up with the Defense Contract Audit Agency (DCAA) on outstanding assist audits before prime contractor and Government agreement on final contract price occurs,

b. Use a contract reopener clause for subsequent redetermination of subcontract costs for significant subcontracts

not negotiated at the time the prime contractor and the Government agree on contract price when it is known that an assist audit is in progress or will be requested, or

c. Delay negotiations pending assist audit results.

ASD(P&L) RESPONSE: Partially concur. We will issue a memorandum that emphasizes follow up with DCAA on outstanding assist audits before agreement on final price.

RECOMMENDATION D.2.: That the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in Recommendation D.1., as material internal control weaknesses using procedures established in DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. Deleted

ASD(P&L) RESPONSE: Nonconcur. See response to Recommendation A.2.

OFFICE OF THE COMPTROLLER OF THE DEPARTMENT OF DEFENSE

WASHINGTON, DC 20301-1100

(Management Systems)

NOV 30 1989

Final Report
Recommendation

MEMORANDUM FOR DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE

SUBJECT: DoD IG Draft Report on the Audit of the Evaluation Of Subcontract Price Proposals (Project No. 8CE-0001)

Thank you for giving us the opportunity to comment on the subject report. Although the report does not contain any recommendations directed at the DoD Comptroller, we are concerned that the Defense Contract Audit Agency (DCAA) efforts are properly and effectively utilized. This is considered an integral part of the DoD Comptroller's responsibility of providing direction, authority and control over DCAA.

It is vital to effective contract pricing that subcontract price proposals are audited and the results incorporated in the overall contract price. Your findings that DCAA is performing audits where the Government is receiving no benefits (Finding C, "Use of Government Assist Audits"), and where the prime contractor but not the Government may benefit (Finding D, "Government Assist Audits Published After Contract Price Negotiations") are disturbing. As proposal audits have the highest priority for accomplishment by DCAA, the audits identified in your report were accomplished at the expense of performing other critical audits such as overhead and defective pricing reviews. The DCAA should perform the subcontract price proposal audits where they are required and the contracting officers should make effective use of the audit results. Deleted C

Actions required to implement recommendations C.1, D.1.a and D.3 in the subject report appear to be warranted and, hopefully, would result in better utilization of DCAA's limited audit resources by the contracting officer. Deleted C.1.a C.2

Should you have any questions, please contact Tom Summers at 693-6502.

Roger Wm. Cowles
Acting Director
Contract Audit and Analysis

DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY
WASHINGTON, DC 20310-0103

07 DEC 1989

SFRD-KP

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE (AUDITING), 400 ARMY NAVY DRIVE, ARLINGTON, VIRGINIA 22202

SUBJECT: IG DoD Draft Report on the Audit of the Evaluation of Subcontract Price Proposals (8CE-0001)

1. We have reviewed the draft report of audit number 8CE-0001, as well as the responses to it by U.S. Army Tank Automotive Command (TACOM) and U.S. Army Missile Command (MICOM) (enclosed). We concur with the actions proposed and taken by these commands.

2. Point of contact is LTC Dan K. Edwards, Jr., SFRD-KP, Commercial (202) 697-0946, AUTOVON 227-0946.

Enclosures

Nicholas R. Hurst
NICHOLAS R. HURST
Brigadier General, GS
Director of Contracting

CF:
SAIG-PA

HEADQUARTERS, U. S. ARMY MATERIEL COMMAND
5001 EISENHOWER AVENUE, ALEXANDRIA, VA 22333-0001

AMCIR-A (36-2)

29 Nov 89

Final Report
Recommendation

MEMORANDUM FOR HQDA(SAIG-PA), WASH DC 20310-1734

SUBJECT: DODIG Draft Report, Evaluation of Subcontract Price Proposals (AMC No. D8755)

1. We are enclosing the positions on recommendations D-3 (TACOM) and E-3 (MICOM) IAW AR 36-2. We concur with the actions taken or proposed by TACOMC-2,D-3 and MICOM.

2. Point of contact for this audit is Mr. Robert Kurzer, 202-274-9023.

FOR THE COMMANDER:

Leonard H. Maguire

LEONARD H. MAGUIRE
Chief, Internal Review and
Audit Compliance Office

Encl
as

DEPARTMENT OF THE ARMY
UNITED STATES ARMY MISSILE COMMAND
REDSTONE ARSENAL, ALABAMA 35898-5000

REPLY TO
ATTENTION OF

14 NOV 1989

AMSMI-IR (36-2)

Final Report
Recommendation

MEMORANDUM FOR Commander, U.S. Army Materiel Command,
ATTN: AMCIR-A, 5001 Eisenhower Avenue,
Alexandria, VA 22333-0001

SUBJECT: DODIG Draft Report, Evaluation of Subcontract Price Proposals (AMC No. D8755)

1. Reference Memorandum, HQ AMC, AMCIR-A, 23 Oct 89, subject as above.

2. In accordance with referenced memorandum, the proposed AMC position to Recommendation E-3 of the subject draft report is enclosed. D-3

Encl

Ernest A. Young
ERNEST A. YOUNG
Deputy for Procurement and Readiness

AN EQUAL OPPORTUNITY EMPLOYER

Command Reply

Final Report
Recommendation

DODIC Draft Report,
Evaluation of Subcontract Price Proposals

RECOMMENDATION E-3: "We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition):

D-3

a. Request the cognizant procurement contracting officer at the U.S. Army Missile Command to monitor the progress of the responsible Defense Contract Audit Agency office that has agreed to perform a comprehensive defective pricing review based on our referral of potential defective pricing of $79,964 on Contract Number DAAH01-87-C-0220.

b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended."

ACTION TAKEN: Concur. The procuring contracting officer at the U.S. Army Missile Command (MICOM) has contacted the Defense Contract Audit Agency (DCAA) relative to a defective pricing review on contract number DAAH01-87-C-0220. DCAA advised that an audit report will be submitted to the MICOM Procurement Directorate by 30 Nov 89. Upon receipt of the audit report from DCAA, the procuring contracting officer will negotiate and recover any funds due the government. Target completion date is 31 Mar 90.

DEPARTMENT OF THE ARMY

UNITED STATES ARMY TANK-AUTOMOTIVE COMMAND
WARREN, MICHIGAN 48397-5000

REPLY TO ATTENTION OF

AMSTA-CJA (36-2b)

Final Repo
Recommendati

MEMORANDUM FOR Commander, U.S. Army Material Command, ATTN: AMCIR-A, 5001 Eisenhower Avenue, Alexandria, VA 22333-0001

SUBJECT: DODIG Draft Report, Evaluation of Subcontract Price Proposals, Project 8CE-0001 (AMC No. D8755)

1. Reference memorandum, AMC, AMCIR-A, dated 23 October 1989, SAB.

2. This memorandum is to advise you of our nonconcurrence with the auditors' conclusion that the Government did not receive any benefits from the assist audits performed on contract DAAE07-86-C-A050. We concur, however, with audit Recommendations 3a and 3b. The rationale for our position is contained in our reply (Enclosure).

3. Our review of the draft report showed no reason to classify or protectively mark any portion. Also, the draft report does not contain any operations security information which needs to be protected. C.2.a. and C.2.b.

Encl

LEO J. FIGATY
Major General, USA
Commanding

COMMAND REPLY
DOD Inspector General Draft Report Project No. 8CH-0001
Audit of the Evaluation of Subcontract Price Proposals
U.S. Army Tank-Automotive Command

Final Repor
Recommendatio

FINDING D: Government Assist Audits Published After Contract Price Negotiations.

C

The Government made audits of subcontract proposals for which it did not receive any benefits. This situation occurred because contracting officers did not always followup with the Defense Contract Audit Agency (DCAA) on outstanding assist audit reports before reaching the final agreement on contract price or they did not delay negotiations pending assist audit results for subcontract costs. Also, contracting officers requested, and DCAA performed assist audits after the prime contractor and the Government agreed on a firm-fixed contract price. In these situations, contracting officers wasted DOD contract audit resources. As a result, we projected that DCAA performed 76 assist audits costing $169,742 in audit resources, which had potential benefits to the prime contractor, but the Government did not receive any benefits.

COMMENTS ON FINDING D: Nonconcur. Regarding contract DAAE07-85-C-A050, we disagree with the auditors' conclusion that the Government did not receive any benefits from assist audits performed after the prime contractor and the Government agreed on a firm-fixed contract price. In negotiating firm-fixed price contracts, the U.S. Army Tank-Automotive Command generally agrees to provide assist audits, as necessary, for the prime contractor in exchange for a decrement factor on the contract price. In effect, the Government receives its monetary benefits for assist audits in the form of reduced prices at the time the contract is awarded. C

ADDITIONAL FACTS: Appendix A, titled "SCHEDULE OF SAMPLED CONTRACTS", report page 51 shows a value of contract action of $470,922,000 for contract number DAAE07-85-C-A050-009/015. The value of modifications P00009 and P00015 is $440,523,974. The amount currently shown on page 51 in the report reflects the value of four modifications: P00009, P00011, P00015, and P00020.

RECOMMENDATION 3a: We recommend that the Commander, TACOM issue policy guidance to contracting officers that ensures that requests for assist audits of subcontractor price proposals are made sufficiently in advance of price negotiations so that results may be used in developing negotiations objectives. C.2.a.

ACTION TAKEN: Concur. The recommended policy guidance will be issued to the contracting officers by 31 January 1990.

COMMAND REPLY
DOD Inspector General Draft Report Project No. 8CE-0001
Audit of the Evaluation of Subcontract Price Proposals
U.S. Army Tank-Automotive Command

Final Report Recommendation C.2.b.

RECOMMENDATION 3b: We recommend that the Commander, TACOM issue policy guidance to contracting officers that ensures that any requests for assist audits after price negotiations on firm-fixed price contracts are only made if there will be a potential direct monetary benefit (i.e., price reduction) to the Government on the immediate contract.

ACTION TAKEN: Concur. The recommended policy guidance will be issued to contracting officers with the stipulation that requests for assist audits after contract award on firm-fixed price contracts will be made only if (i) it is believed that the assist audits will result in a potential direct monetary benefit to the Government on the immediate contract, or (ii) they can be directly linked to decrement factors which were agreed to by the prime contractor during contract negotiations. This guidance will be issued by 31 January 1990.

DEPARTMENT OF THE NAVY
THE ASSISTANT SECRETARY OF THE NAVY
SHIPBUILDING AND LOGISTICS
WASHINGTON DC 20360 5000

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL
(DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE)

Subj: DRAFT REPORT ON THE AUDIT OF THE EVALUATION OF SUBCONTRACT PRICE PROPOSALS (PROJECT NO. 8CE-0001)

Encl: (1) Navy Comments on 8CE-0001

Enclosure (1) provides our comments on the subject report. We concurred in part with findings A, B, C, D and E. We nonconcurred with a variety of the recommendations. Please see enclosure (1) for the details as they are too voluminous to synopsize here.

The point of contact for this correspondence is Mr. Anthony DeVico at 692-8657.

Frank Swofford

FRANK W. SWOFFORD
By Direction of the Secretary of the Navy

Copy to:
NCB-53
NAVINSGEN

NAVY COMMENTS ON 8CE-0001

Finding A. Prime Contractors Realize Significant Savings on Subcontracted Items

Prime contractors realized significant savings on subcontracted items by not providing the Government with the results of their subcontract cost analyses for subcontracts that they negotiated subsequent to reaching agreement on prime contract price. This occurred because DOD procurement officials were not taking sufficient actions to ensure that subcontract cost or pricing data were complete and submitted in a timely manner as required by the Federal Acquisition Regulation. Also, procurement officials did not protect the Government's interest when subcontract negotiations were not completed until after Government/prime contractor negotiations. We found that 44.7 percent of noncompetitive subcontracted items were negotiated by prime contractors after reaching agreement on contract price with the Government. Prime contractors also negotiated competitive and dual-source subcontracts after negotiating final contract prices with the Government. We projected that prime contractors negotiated subcontract cost reductions totaling $93,781,430 after negotiations were completed with the Government. However, the savings were not passed on to DOD. As a result, FY 1986 and 1987 firm-fixed-price contract actions, negotiated at $10 million or more in FY 1987, were overpriced by $94 million in base subcontract costs.

Navy Response - Concur in part. Comments on specific issues are addressed in our responses to the recommendations.

DODIG Recommendations:

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to Military Departments and Defense agencies emphasizing the need for contracting officers to require prime contractors to:

   a. Submit proposals in Federal Acquisition Regulation table 15-2 format.

   b. Obtain results of prime contractor's cost analyses before negotiations.

   c. Apply decrement factors to the proposed price of undefinitized, noncompetitive proposed parts that are not significant.

ENCLOSURE( )

d. Use negotiated reopener clauses in firm-fixed-price contracts when substantial subcontract costs have not been negotiated before agreement on price or delay contract negotiations until these subcontracts have been negotiated.

2. We recommend that the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in recommendation 1, as material internal control weaknesses using procedures established in DOD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

3. We recommend that the Director, Defense Contract Audit Agency, issue guidance establishing a requirement that Audit Reports on Evaluation of Initial Price Proposal identify purchase orders and subcontracts exceeding $100,000, for which the Federal Acquisition Regulation required cost analyses have not been performed by the prime contractor.

4. We recommend that the Director, Defense Logistics Agency, issue a policy memorandum to financial services personnel emphasizing the requirement to conduct and document preanalysis meetings, which establish the party responsible for analysis of each proposed cost element.

Navy Response - Concur with recommendations 1.a., 1.b., and 1.c. based on removal of "that are not significant" from 1.c. Application of decrement factors to all undefinitized, noncompetitive proposal prices based on an analysis is good and normal contract negotiation.

1.d. Nonconcur. Use of reopener clauses on fixed price contracts as described in the recommendation is not sound pricing policy. We should perform an analysis and apply an appropriate decrement factor for all undefinitized, noncompetitive parts. If the reopener clause is for downward adjustment only, the contractor has no incentive to negotiate the subcontract at a lower price than what is called out in the prime contract since the price, and profit, of the prime contract will be reduced accordingly. The contractor must give back profit dollars. If the reopener clause allows for upward adjustment as well, then a "cost plus a percentage of cost" environment exists where the higher the negotiated price of the subcontract, the more profit dollars the contractor will receive when the prime contract is repriced.

Allowing the contractor to keep dollars achieved by reducing subcontract prices or absorb price increases above that which is negotiated, acts as an incentive to the contractor and provides the government with lower base line costs upon which to negotiate follow on production contracts. The lower subcontract costs would be revealed in the cost and pricing data submitted with the proposal for the next procurement. The instant benefits that accrued to the contractor are offset by the benefits that accrue to the government in future purchases.

The DODIG position may have some validity for one time buys, in which case, negotiators must be particularly vigilant when pricing and negotiating the contract to assure themselves that subcontract prices are reasonable. However, in situations where follow on buys are being made, the use of reopener clauses will be detrimental to the government, since their use will result in higher baseline costs upon which the follow on proposals will be based. For these same reasons, we nonconcur with the recommendation to delay negotiations with the prime contractor until the subcontracts are negotiated.

2. Nonconcur. Based on our nonconcurrence with recommendation 1.d., we do not believe there are any material internal control weaknesses.

3. The Navy has no comment on this recommendation.

4. Nonconcur. Conducting and documenting preanalysis meetings is a needless and burdensome effort. Major areas of responsibility are already set forth in the FAR and DFARS. Remaining issues can be resolved through normal PCO/ACO/DCAA interfaces which occur during proposal analysis and negotiation.

Finding B. Analysis of Competitive Subcontractor Proposals

The Government did not receive any monetary benefit from prime contractor analyses and subsequent negotiations of competitive subcontract proposals. This situation occurred because contracting officers were not aware of prime contractor analyses of competitive subcontract proposals because the Federal Acquisition Regulation (FAR) and DOD FAR Supplement do not require cost analysis of competitive subcontracts. Prime contractors also did not apply decrement factors to competitively proposed subcontracts. As a result, prime contractors negotiated savings of $13.3 million in competitive subcontract costs, which were not passed on to the Government.

Navy Response - Concur in part. Contracting personnel should obtain contractor analysis of competitive subcontracts including prior actual expenses.

DODIG Recommendations:

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) include coverage of competitive and dual-source items in its policy memorandum issued to the Military Departments and Defense agencies in response to recommendation 1 to Finding A. The policy memorandum should emphasize the need for contracting officers to require prime contractors to submit proposals in Federal Acquisition Regulation table 15-2 format, obtain results of prime contractor's cost analyses before negotiations, and apply decrement factors to noncompetitive, competitive and dual-source proposed parts whenever the contractor has a history of negotiating lower prices with its subcontractors and the proposed subcontract costs are not significant, or use negotiated reopener clauses in firm-fixed-price contracts where substantial subcontract costs have not been negotiated before agreement on price, or delay contract negotiations until these subcontracts have been negotiated.

2. We recommend that the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in recommendation 1, as material internal control weaknesses using procedures established in DOD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

3. To strengthen internal controls, we recommend that the Director, Defense Contract Audit Agency, expand its audit guidance for surveys of contractor estimating systems to include identification in estimating systems survey reports of contractors who have written policies or actual practices of negotiating competitive or dual-source quotes.

Navy Response - Concur in part with recommendation 1. It should be revised to reflect our suggestions for recommendations A.1.a. and A.1.b. We nonconcur with the portion of this recommendation that suggests use of reopener clauses or delaying contract negotiations. See our comments on recommendation A.1.d.

The key to this issue is the adequacy of price competition. It is the responsibility of the contractor to document, and the negotiator to review, the adequacy of competition. In cases where additional reductions were achieved in subcontract prices, there may not have been competition to begin with. Or the reductions may be examples of prime contractors using the strength of their position to achieve further reductions to already competitive prices. In either case, the government obtains the benefits of their reductions in subsequent negotiations through the analysis of actual negotiated costs.

2. Nonconcur. As with recommendation A.2, we do not believe there are any material internal control weaknesses.

3. The Navy has no comment on this recommendation.

Finding C. Use of Government Assist Audits

Deleted

Contracting officers did not always use or did not document their use of Government assist audits in negotiating contract prices. This situation was caused by contracting officers either not complying with the Federal Acquisition Regulation (FAR) and DOD FAR Supplement or not using assist audits because prime contractors had concluded subcontract negotiations before the audit results were known. Based on our statistical sample, we projected that the Defense Contract Audit Agency (DCAA) performed 90 Assist audits costing $248,692 in audit resources for which the Government received no benefit. Failure to use Government assist audits could result in overpricing of subcontract costs. Further, failure to document the disposition of assist audit report recommendations could hinder management's ability to evaluate the effectiveness of contract negotiations and DCAA's ability to measure the quality and effectiveness of its audit services.

Navy Response - Concur in part. We agree that contract negotiators may not always adequately document the file regarding the use or nonuse of subcontract assist audits. We do not agree that this results only from either failure to comply with the FAR or not using the assist audits because prime contractors had concluded negotiations before the audit report was complete. The audit reports may have been erroneous, late or of inconsequential value.

We agree that failure to use the assist audit report might result in contract overpricing but, again, would point out the benefits that would flow to the government during follow on negotiations. We do not agree that failure to document use of audit report recommendations hinders management's ability to evaluate the negotiation process. Contract negotiations is much more than the resolution of audit recommendations.

DODIG Recommendations:

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense agencies that emphasizes to contracting officers the need to use assist audit results in developing negotiation positions and to document the use of assist audit results in the price negotiation memorandum.

2. We recommend that the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in recommendation 1, as material internal control weaknesses using procedures established in DOD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

Navy Response - Concur in part with recommendation 1. Existing policy and FAR/DFARS/Naval Acquisition Procedures Supplement (NAPS) guidance is adequate regarding the contracting officer's responsibilities, however; it may be appropriate for ASD(P&L) to address procedures for DCAA to begin subcontract assist audits without waiting for contracting officer requests. Lines of authority between DCAA prime and subcontract auditors should also be addressed to ensure that assist auditors are held accountable for timely submission of their subcontract analysis to the DCAA prime contractor auditor. Timely submission of subcontract assist audits is crucial to ensuring their use.

Contract negotiators and auditors must both plan in advance how they will handle major proposal submittals. Both must ensure that major subcontractors are identified and acted upon as early in the process as possible. Delaying contract negotiations to wait for assist audits is not a viable avenue. Contract negotiations must commence in a timely manner to ensure that contract award and delivery schedules are met and the Government is not forced to use letter contacts.

2. Nonconcur. We do not believe there are any material internal control weaknesses.

Finding D. Government Assist Audits Published After Contract Price Negotiations C

The Government made audits of subcontract proposals for which it did not receive any benefits. This situation occurred because contracting officers did not always followup with the Defense Contract Audit Agency (DCAA) on outstanding assist audit reports before reaching the final agreement on contract price or they did not delay negotiations pending assist audit results for subcontract costs. Also, contracting officers requested, and DCAA performed, assist audits after the prime contractor and the Government agreed on a firm-fixed contract price. In these situations, contracting officers wasted DOD contract audit resources. As a result, we projected that DCAA performed 76 assist audits costing $169,742 in audit resources, which had potential benefits to the prime contractor, but the Government did not receive any benefits.

Navy Response - Concur in part. There may be instances when contracting officers do not follow up with auditors on outstanding assist audits and do request audits after the prime contract price has been agreed to. We do not agree with the conclusion that these actions always result in wasted contract audit resources and that the government never receives any benefits.

Failure to follow up may be a failure to document why it was not necessary to await the final official audit results. Previous discussions with auditors may have already provided any significant input required or the contracting officer may have determined that the results would not be of significant impact on the overall negotiations.

Audit reports requested after agreement on price can still be used by both the contractor and or the government as references for future acquisitions. If the audits result in lower subcontract prices on the instant contract these lower prices will become the baseline for follow on negotiations.

DODIG Recommendations:

1. We recommend that the Assistant Secretary of Defense (Production and Logistics) issue a policy memorandum to the Military Departments and Defense agencies that emphasizes to contracting officers the need to:

a. Follow up with the Defense Contract Audit Agency on outstanding assist audits before prime contractor and Government agreement on final contract price occurs,

b. Use of a contract reopener clause for subsequent redetermination of subcontract costs for significant subcontracts not negotiated at the time the prime contractor and the Government agree on contract price when it is known that an assist audit is in progress or will be requested, or

c. Delay negotiations pending assist audit results.

2. We recommend that the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed in recommendation 1, as material internal control weaknesses using procedures established in DOD Directive 5010.38, "Internal Management Control Program," April 14, 1987.

3. We recommend that the Commander, U.S. Army Tank-Automotive Command, issue policy guidance to its contracting officers that ensures:

a. Requests for assist audits of subcontractor price proposals are made sufficiently in advance of price negotiations so that results may be used in developing negotiation objectives.

b. Any requests for assist audits after price negotiations on firm-fixed price contracts are only made if there will be a potential direct monetary benefit (i.e., price reduction) to the Government on the immediate contract.

Navy Response - Nonconcur with recommendations 1.a., 1.b. and 1.c. Additional policy in these areas is not necessary. Follow-up can be addressed via regular chain of command. We have discussed in ample detail our objections to the use of reopener clauses and delaying negotiations.

2. Nonconcur - We do not believe there are any material internal control weaknesses.

3. We have no comment on this recommendation as it does not pertain to the Navy.

Finding E. Defective Pricing of Nine Contracts

Nine contractors violated the provisions of the Truth in Negotiations Act, as amended (formerly codified at 10 U.S.C, title 10, section 2306(f)), by not providing accurate, complete, and current cost or pricing data in support of their subcontract costs. These nine contractors did not provide the Government negotiator with the most current quotes available, did not update proposals to reflect subcontract prices negotiated before agreement on prime contract price, or did not disclose results of their cost analyses and negotiation targets for undefinitized subcontracts developed before agreement on contract price. As a result, these nine contracts were potentially defectively priced by $1.47 million. All potential defective pricing has been referred to cognizant DCAA offices and will be incorporated into their comprehensive defective pricing reviews.

Navy Response - Concur in part. Comments on specific issues are addressed in our responses to the recommendations.

DODIG Recommendations:

1. We recommend that the Assistant Secretary of the Navy (Shipbuilding and Logistics):

   a. Request the cognizant procurement contracting officers to monitor the progress of the responsible Defense Contract Audit Agency offices that have agreed to perform comprehensive defective pricing reviews on the following contracts, based on our referral of potential defective pricing of $1,147,229.

Contract	Defective Amount
N00019-86-C-0326	$ 686,303
N00019-87-C-0052	33,454
N00024-86-C-5212	184,250
N00024-87-C-6318	17,098
N00024-87-C-6066	138,107
N00039-87-C-0088	88,017
	$ 1,147,229

   b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended.

2. We recommend that the Assistant Secretary of the Air Force (Acquisition):

   a. Request the cognizant procurement contracting officer to monitor the progress of the responsible Defense Contract Audit Agency office that has agreed to perform comprehensive defective pricing reviews based on our referral of potential defective pricing of $244,009 on the following contracts.

CONTRACT	Defective Amount
F33657-86-C-0068	$104,758
F34601-87-C-2269	139,251
	$244,009

   b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended.

3. We recommend that the Assistant Secretary of the Army (Research, Development and Acquisition):

   a. Request the cognizant procurement contracting officer at the U.S. Army Missile Command to monitor the progress of the responsible Defense Contract Audit Agency office that has agreed to perform a comprehensive defective pricing review based on our referral of potential defective pricing of $79,964 on Contract Number DAAH 01-87-C-0220.

   b. Take appropriate action to recover any contract overpricing pursuant to the Truth in Negotiations Act, as amended.

Navy Response - Nonconcur with recommendation 1.a. It is not appropriate nor is there time for Navy contracting officers to monitor DCAA auditors. If DCAA believes there is defective pricing, they will notify us and at that time we will take appropriate action.

Concur with recommendation 1.b.

We have no comment on recommendations 2 and 3 as they do not pertain to the Navy.

DEPARTMENT OF THE AIR FORCE
WASHINGTON DC 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

DEC. 5 1989

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
OFFICE OF THE INSPECTOR GENERAL
DEPARTMENT OF DEFENSE

SUBJECT: DOD/IG Draft Report on the Audit of the Evaluation of Subcontract Price Proposals (Project No. 8CE-0001) - INFORMATION MEMORANDUM

This is in reply to your memorandum for Assistant Secretary of the Air Force (Financial Management and Comptroller) requesting comments on the findings and recommendations made in subject report.

As is discussed in the report, the Air Force has been concerned about the area of subcontract pricing. We have recently modified the AFFARS to add coverage related to the use of decrement factors, assist audits, and obtaining prime contractor analyses of subcontractor data. In addition, we have recommended that Contracting Officers delay negotiation of the prime contract, when feasible, pending definitization of subcontracts, conduct joint government/prime contractor analysis of the subcontract proposal and/or decrease prime contractor profit if they are unwilling or unable to provide necessary subcontract proposal analysis.

As the report also notes, the Air Force did not add specific coverage related to the use of reopener clauses. While we concur that there may be times when use of a reopener clause is appropriate, there is nothing which precludes their use now. We do not believe, however, that reopener clauses should be emphasized as a primary tool for use in resolution of subcontract prices. There are other tools available, such as decrement factors, which, when based on contractor history, can provide the government with reasonable assurance of obtaining fair and reasonable prices. Also, reopener clauses can work to our disadvantage if the subcontract price goes up. We do not have the resources to constantly renegotiate contracts nor do we always have the flexibility to delay award pending negotiation of all subcontract costs. There are many times when the most prudent action is to take those steps available to protect the government (e.g., decrement factors, obtaining prime contractor analysis of subcontract proposals, etc.) and negotiate and obtain closure on a given contract. Consequently, we do not concur with the recommendation made throughout the audit report for the Assistant Secretary of Defense (Production and Logistics) to emphasize the need for contracting officers to require prime contractors to use negotiated reopener clauses.

We also do not concur with the various recommendations that the Assistant Secretary of Defense (Production and Logistics) report in the annual Statement of Assurances and track the deficiencies addressed as material internal control weaknesses. While we concur that subcontract pricing is an area of concern, and while the Air Force has taken steps to provide guidance to contracting officers on this issue by amending the AFFARS, we do not believe that this area represents a problem so significant that it warrants definition as a material internal control weakness.

There is only one finding which is specifically addressed to the Air Force. Finding E.2. recommends that the Assistant Secretary of the Air Force (Acquisition) request the PCO to monitor the progress of the responsible DCAA office in performing defective pricing reviews on contracts F33657-86-C-0068 and F34601-87-C-2269 and take appropriate action to recover any contract overpricing. The Air Force concurs with this recommendation and has requested the cognizant PCO take action as necessary to follow up on the defective pricing audits. D.2.

DANIEL S. RAK
Deputy Assistant Secretary
(Acquisition Management & Policy)

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VA 22304-6178

IN REPLY REFER TO

PLD 703.3.3.10 (8CE-0001)

Final Report
Recommendation

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, AUDITING

SUBJECT: Draft Report on the Audit of the Evaluation of Subcontract Price Proposals (Project No. 8CE-0001)

Reference your 5 October 1989 draft report on the subject review. We have reviewed the report and its recommendations, specifically recommendations A3 and B3, and are providing detailed comments. In addition, we are providing comments on those sections of your report entitled, "Assist Audits Published after Contract Negotiations." A3andB2

Please direct any questions regarding this matter to Jacqueline Hlavin, Program Manager, Policy Liaison Division, telephone (202) 274-7521.

FOR THE DIRECTOR:

for William J. Sharkey
Assistant Director
Policy and Plans

Encl
AIG(A) Recommendations and DCAA Responses

AIG(A) Recommendations and DCAA Responses

Recommendation A.3.: We recommend that the Director, Defense Contract Audit Agency, issue guidance establishing a requirement that Audit Reports on Evaluation of Initial Price Proposal identify purchase orders and subcontracts exceeding $100,000, for which the Federal Acquisition Regulation required cost analyses have not been performed by the prime contractor. A.3

DCAA Response: Concur in Principle. We will issue guidance establishing a requirement that Audit Reports on Evaluation of Initial Price Proposals identify purchase orders and subcontracts for which the FAR required cost analyses have not been performed by the prime contractor. In order to stay consistent with FAR 15.806-2(a), our guidance will require identification of purchase orders and subcontracts for each cost estimate that is (1) $1,000,000 or more, (2) both more than $100,000 and more than 10 percent of the prime contractor's proposed price, or (3) considered to be necessary for adequately pricing the prime contract.

Recommendation B. 3.: To strengthen internal controls, we recommend that the Director, Defense Contract Audit Agency, expand its audit guidance for surveys of contractor estimating systems to include identification in estimating system survey reports of contractors who have written policies or actual practices of negotiating competitive or dual-source quotes. B.2

DCAA Response: Non concur. DCAA is currently providing information in relation to contractors who negotiate competitive or dual-source quotes through our use of decrement factors. Part of our review of a contractor's estimating system includes an analysis of negotiated subcontract to proposed subcontract prices and a calculation of an average difference. This average is used to develop a decrement factor which is used in the proposal evaluation. The underlying concept is that the prime contractor will achieve similar reductions on the subcontracts included in the proposal under review. The decrement factor considers both competitive and non-competitive subcontracts. Details supporting the decrement factors are presented in both estimating system survey reports and price proposal reports.

The following are our comments in relation to assist audits requested before, but not published until after, prime contract award.

Report Number	Report Date	Prime Contract Number	Prime Contract Nego. Date	Audit Request Date	Note
12517L210063-7-312	11/25/86	DAAJ09-87-C-A009	11/14/86	09/03/86	1
21807E210057-0437	02/17/87	DAAJ09-87-C-A009	11/14/86	02/16/86	2
22017A210.028	11/24/86	DAAJ09-87-C-A009	11/14/86	09/29/86	3
31017C210155	05/12/87	DAAE07-86-C-A050	03/25/87	12/11/86	4
16718B210015	10/19/87	N00024-87-C-5331	09/17/87	09/17/87	5
3121210061	02/26/87	DAAE07-87-C-A010	02/18/87	10/31/86	6
4181-8D210013	08/12/87	F08635-87-C-0065P002	08/13/87	07/02/87	7

NOTES

1. After review of the audit file it was determined that verbal results of audit were provided to the prime contract ACO on 6 November 1986. These verbal results were then followed up by the written report on 24 November 1986. There were no significant changes from the verbal results to the written report.

2. The audit file indicated that the audit request date was 21 January 1987, not 16 February 1986. The request was sent by the prime contractor's ACO to the subcontractor's DCASMA. This request was dated 16 April 1986. This request did not arrive at DCASMA until 15 January 1987. At that time the subcontractor's DCASMA sent a request to the cognizant DCAA office. It should be noted that the subcontract audit report stated that the dollars in the proposal were out of date and should not be used for negotiations. The subcontract FAO was not informed that negotiations had taken place.

3. It was determined that the subject audit report did go out after the date negotiations were complete. In addition, there were no verbal comments provided to the contracting officer as to the status of the report. However, on 29 October 1986, 15 days prior to the close of negotiations, the auditor requested an extension of the audit report due date to perform additional review on the indirect rates. This extension was granted with no mention of the fact that negotiations were on going or that the negotiations were going to end shortly.

4. The subcontractor's proposal was dated 31 October 1986. The prime contractor request to DCASMA was dated 7 November 1986. The assist request to DCAA was dated 11 December 1986. DCAA acknowledged the request on 23 January 1987. DCAA was delayed in performance of the audit by the contractor. Initially, the contractor would not allow DCAA to enter the facility due to the fact that there was no controller. This situation was remedied and the audit started. The ability to obtain information was hindered and delays ensued. The result was that the contractor was cited for inadequate data on 21 March 1987 and denial of access to records on 30 March 1987. The requested information was finally presented to DCAA in April. At all times, the ACO was informed of the situation. DCAA was not informed of the date of negotiations and no verbal was provided to the contracting officer.

5. The audit was requested on 17 September 1987, the same date that negotiations were completed. Based on this it would have been impossible for DCAA to complete its review so that the information could be considered during negotiations. This audit would more appropriately be classified as an assist audit that was requested and published after prime contract award.

6. When reviewing the subcontractor's proposal, it was determined that the proposal was not adequate and that a new submission was needed. The new submission arrived at the DCAA office on 17 November 1987. However, the data provided was still not adequate. Due to the problems that were experienced, a request for extension was made and coordinated with the ACO. The DCAA office at the subcontractor was not made aware that negotiations were taking place and did not provide verbal results of audit to the contracting officer.

7. On 11 February 1987, the prime contractor's DCASMA requested the subcontractor's cognizant DCASMA to perform a review. The proposal was not received and request for audit not made until 2 July 1987. On 8 July 1987, the PCO contacted the DCAA office and requested and received information in relation to the subcontractor's rates. DCAA completed the review after receiving an extension on the due date of the audit. The subcontract DCAA office was unaware of the fact that negotiations were almost complete. It should be noted that there were insignificant cost questioned for other than rates.

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22304-6100

7 DEC 1989

IN REPLY REFER TO DLA-CI

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
DEPARTMENT OF DEFENSE

SUBJECT: Draft Report on the Audit of the Evaluation of Subcontract Price Proposals (Project No. 8CE-0001)

The enclosed positions are provided in response to your memorandum dated 5 October 1989 requesting comments to the draft report.

FOR THE DIRECTOR:

2 Encl

Stephen J. Zavada, Jr.
STEPHEN J. ZAVADA, JR.
Acting Chief
Internal Review Division
Office of Comptroller

TYPE OF REPORT: AUDIT DATE OF POSITION 7 Dec 89

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO.: Draft Report on the Audit of the Evaluation of Subcontract Price Proposals (Project No. 8CE-0001)

FINDING A. Prime Contractors Realize Significant Savings on Subcontracted Items. Prime contractors realized significant savings on subcontracted items by not providing the Government with the results of their subcontract cost analyses for subcontracts that they negotiated subsequent to reaching agreement on prime contract price. This occurred because DoD procurement officials were not taking sufficient actions to ensure that subcontract cost or pricing data were complete and submitted in a timely manner as required by the Federal Acquisition Regulation. Also, procurement officials did not protect the Government's interest when subcontract negotiations were not completed until after Government/prime contractor negotiations. We found that 44.7 percent of noncompetitive subcontracted items were negotiated by prime contractors after reaching agreement on contract price with the Government. Prime contractors also negotiated competitive and dual-source subcontracts after negotiating final contract prices with the Government. We projected that prime contractors negotiated subcontract cost reductions totaling $93,781,430 after negotiations were completed with the Government. However, the savings were not passed on to DoD. As a result, FY 1986 and 1987 firm-fixed-price contract actions, negotiated at $10 million or more in FY 1987, were overpriced by $94 million in base subcontract costs.

DLA COMMENTS: Due to the broad-based nature of this finding, DLA cannot comment on this finding.

MONETARY BENEFITS DLA comments are not appropriate.
DLA COMMENTS:
ESTIMATED REALIZATION DATE
AMOUNT REALIZED
DATE BENEFITS REALIZED

ACTION OFFICER Steven W. Swart DLA-AF, 47511

DLA APPROVAL William J. Cassell

TYPE OF REPORT: AUDIT DATE OF POSITION: 7 Dec 89

PURPOSE OF INPUT: INITIAL POSITION

AUDIT TITLE AND NO.: Draft Report on the Audit of the Evaluation of Subcontract Price Proposals (Project No. 8CE-0001)

RECOMMENDATION A.4.: We recommend that the Director, Defense Logistics Agency, issue a policy memorandum to financial services personnel emphasizing the requirement to conduct and document preanalysis meetings, which establish the party responsible for analysis of each proposed cost element.

DLA COMMENTS: Partially concur with recommendation. We will issue a policy memorandum to Financial Services personnel emphasizing the requirement to conduct and document preanalysis meetings. The preanalysis meetings were adopted to determine on a case-by-case basis the adequacy of the contractor's proposal before the pricing team members begin the field pricing review to avoid premature analysis.

During the proposal review process, if all items are not reviewed independently by the price analyst, assist reviews are requested from technical specialists and the auditor to assure each proposed cost element is evaluated.

Absence of preanalysis meetings, which are held to review the adequacy of proposals, is not a material internal control weakness. The quality of the proposal review is assured by the supervisor who is responsible for reviewing all pricing reports and supporting documentation in detail and giving approval of the report by cosigning.

DISPOSITION:
(X) Action is ongoing: Final Estimated Completion Date: 21 Dec 89
( ) Action is considered complete.

MONETARY BENEFITS: None.
DLA COMMENTS
ESTIMATED REALIZATION DATE:
AMOUNT REALIZED.
DATE BENEFITS REALIZED.

ACTION OFFICER: Steven W. Swart, DLA-AF, 47611

DLA APPROVAL: William J. Cassell

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics), Washington, DC

Department of the Army

Armament, Munitions, and Chemical Command, Rock Island, IL
Aviation Systems Command, St. Louis, MO
Communications and Electronics Readiness Command, Fort Monmouth, NJ
Missile Command, Redstone Arsenal, AL
Tank Automotive Material Readiness Command, Warren, MI
Plant Representative Office, McDonnell Douglas Helicopter Co., Mesa, AZ

Department of the Navy

Naval Air Systems Command, Washington, DC
Naval Sea Systems Command, Washington, DC
Space and Naval Warfare Systems Command, Washington, DC
Naval Plant Representative Offices:
- General Electric, Pittsfield, MA
- UNISYS Corp., Great Neck, NY
- Grumman Aerospace Corp., Bethpage, NY

Department of the Air Force

Aeronautical Systems Division, Wright-Patterson Air Force Base, OH
Deputy for Contracting and Manufacturing, Eglin AFB, FL
Military Airlift Command, Scott AFB, IL
Oklahoma City Air Logistics Center, Tinker AFB, OK
Air Force Plant Representative Offices:
- Morton-Thiokol, Brigham City, UT
- Lockheed Georgia, Marietta, GA
- Rockwell International, Anaheim, CA
- Hughes Aircraft Co., Los Angeles, CA
- LTV Missiles and Electronics Group, Dallas, TX
- Boeing Military Airplane Co., Wichita, KS

ACTIVITIES VISITED OR CONTACTED (Continued)

Other Defense Activities

Headquarters, Defense Contract Audit Agency, Alexandria, VA
Headquarters, Defense Logistics Agency, Alexandria, VA
Defense Contract Audit Agency Field Locations:
- Akron Branch Office, Akron, OH
- Binghamton Branch Office, IBM Suboffice, Vestal, NY
- Denver Branch Office, Colorado Springs Suboffice, Colorado Springs, CO
- Indianapolis Mobile Branch Office, Fort Benjamin Harrison, IN
- Loral Electronics Systems Suboffice, Yonkers, NY
- National Branch Office, IBM Manassas Suboffice, Manassas, VA
- North County Branch Office, San Diego, CA
- Richardson Branch Office, Richardson, TX
- Resident Office - Boeing Military Airplane, Wichita, KS
- Resident Office - Honeywell, Inc., Hopkins, MN
- Resident Office - Grumman Aerospace Corp., Bethpage, NY
- Resident Office - Hughes Aircraft Co., El Segundo, CA
- Resident Office - Hughes Aircraft Co., Fullerton, CA
- Resident Office - Lockheed-Georgia Co., Marietta, GA
- Resident Office - LTV Corp., Dallas, TX
- Resident Office - McDonnell Douglas, Mesa, AZ
- Resident Office - Raytheon Co., Andover, MA
- Resident Office - Rockwell International, Anaheim, CA
- Resident Office - Texas Instruments, Richardson, TX
- Resident Office - Textron Lycoming, Stratford, CT
- Resident Office - UNISYS, Great Neck, NY

Defense Contract Administration Plant Representative Offices:
- GM Allison Transmission Div., Indianapolis, IN
- General Electric, Wilmington, MA
- Honeywell, Minneapolis, MN
- Hughes Aircraft, Fullerton, CA
- International Business Machines, Manassas, VA
- International Business Machines, Owego, NY
- Loral Corp., Akron, OH
- Loral Corp., Yonkers, NY
- Raytheon Corp., Burlington, MA
- Rockwell International, Richardson, TX
- Texas Instruments, Inc., Dallas, TX
- Textron Lycoming, Stratford, CT

Defense Contract Administration Management Area:
- Colorado Springs, CO
- Fort Benjamin Harrison, IN
- Phoenix, AZ
- San Diego, CA

ACTIVITIES VISITED OR CONTACTED (Continued)

Contractors

B.F. Goodrich, Aircraft Brake Div., Troy, OH
Boeing Military Airplane Co., Wichita, KS
Cubic Corp., San Diego, CA
Cummins Engine Co., Columbus, IN
Ford Aerospace and Communication Corp., Space Missions Div., Colorado Springs, CO
General Electric Company, Ordnance Systems Div., Pittsfield, MA
General Electric Company, Mechanical Drive Turbine and Compressor Department, Fitchburg, MA
GM Allison Transmission Div., Indianapolis, IN
Grumman Aerospace Corp., Bethpage, NY
Honeywell, Inc., Underwater Systems Div., Hopkins, MN
Hughes Aircraft Co., Electro-Optical and Data Systems Group, El Segundo, CA
Hughes Aircraft Co., Ground Systems Group, Fullerton, CA
International Business Machines Corp., Federal Systems Division, Manassas, VA
International Business Machines Corp., Federal Systems Division, Owego, NY
Lockheed Corp., Lockheed-Georgia Div., Marietta, GA
Loral Defense Systems, Akron, OH
LTV Missiles and Electronics Group, Dallas, TX
McDonnell Douglas Helicopter Co., Mesa, AZ
Morton-Thiokol Inc., Tactical Div., Brigham City, UT
Motorola Inc., Scottsdale, AZ
Raytheon Co., Missile Systems Division, Lowell, MA
Raytheon Co., Missile Systems Div., West Andover, MA
Rockwell International, Autonetics Marine Systems Div., Anaheim, CA
Rockwell International, Richardson, TX
Texas Instruments, Inc., Defense Systems & Electronics Group, Dallas, TX
Textron Lycoming, Stratford, CT
UNISYS Corp., Shipboard and Ground Systems Group, Great Neck, NY

FINAL REPORT DISTRIBUTION

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Assistant Secretary of Defense (Public Affairs)

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Assistant Secretary of the Army (Research, Development and Acquisition)
Commander, Army Materiel Command
Commander, U.S. Army Tank-Automotive Command
Army Inspector General

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Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Ranking Minority Member, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations

AUDIT TEAM MEMBERS

James. J. McHale, Acting Director, Contract Management Directorate
Salvatore D. Guli, Program Director
James R. Peterson, Project Manager
Curt Carter, Team Leader
Richard Hanley, Team Leader
Bobbie Sau Wan, Team Leader
Arthur M. Hainer, Auditor
James E. Massey, Auditor
Janet Northam, Auditor
Fred Bell, Auditor
Ted Paulson, Auditor
Hilary Rubin, Auditor