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STATEMENT OF  
ELMER B. STAATS, COMPTROLLER GENERAL OF THE UNITED STATES  
BEFORE THE  
SUBCOMMITTEE ON ECONOMY IN THE GOVERNMENT  
JOINT ECONOMIC COMMITTEE  
ON  
ECONOMY IN GOVERNMENT



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Mr. Chairman and Members of the Committee:

I am pleased to appear before this subcommittee today to discuss the status of certain matters of interest to you which came to light during the hearings in May 1967. As agreed with you, Mr. Chairman, my statement will cover several of the more significant areas in which we have been actively engaged since May as follows:

1. Truth in Negotiations Act, Public Law 87-653.
2. Military Supply Systems.
3. Control over Government Property in Possession.  
of Defense Contractors.
4. Contractor Versus In-house Methods of Acquiring Goods and  
Services.
5. Small Purchases.

In addition, we are furnishing your Subcommittee a summary of the status of other matters mentioned for follow-up in your report of July 1967.

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TRUTH IN NEGOTIATIONS ACT, PUBLIC LAW 87-653

The Truth in Negotiations Act of 1962 (Public Law 87-653), requires submission and certification by the contractor of cost or pricing data prior to the award of certain negotiated contracts and subcontracts expected to exceed \$100,000.

It also requires, as a further protection of the Government's interests, that a defective-pricing-data clause be inserted in each such negotiated contract to provide a contractual basis for a price adjustment in the event the cost or pricing data submitted at the time of negotiation were inaccurate, incomplete, or noncurrent, and as a result the contract price was increased.

During hearings before your Committee in May 1967 we discussed the findings disclosed in our reports to the Congress and a draft report to the Secretary of Defense. In these reports we recommended the following:

1. Obtaining right of access by agency officials to performance cost information.
2. Instituting a regular program of postaward audits, by Defense Contract Audit Agency.
3. Making postaward audits where contracting officers have reason to believe that cost or pricing data used in negotiations may not have been accurate, current and complete, or may not have been adequately verified.
4. Obtaining written identification of data submitted by the contractor in support of pricing proposals.
5. Revising the regulations to make it clear that the

mere making available of data to the auditors without identification in writing does not constitute data "submitted".

6. Documenting procurement files where cost or pricing data were not requested or used to show the basis for concluding that the submission of such data could be waived because of adequate competition or prices that were based on catalog or market prices of a commercial item sold in substantial quantities to the general public.

The foregoing matters dealt not with whether data was being acquired, but with (a) identifying the data obtained, (b) performing adequate analysis and verification of the data and (c) documenting the negotiation files to provide a clear record of the use accorded such data.

The Defense Contract Audit Agency initiated a program for postaward audits, and as you know, Mr. Chairman, on September 29, 1967, the Deputy Secretary of Defense issued a memorandum requiring the inclusion of a clause in all non-competitive firm fixed-price contracts granting access to contractor's records of performance. This memorandum should accomplish by administrative action what would be accomplished by the enactment of bills proposed by you and Congressman Minshall. All other contract types already provide such access.

The Department has revised its regulations to adopt substantially all of our recommendations on the other matters which I have just mentioned.

## Application Of P. L. 87-653 to Construction Contracts

Our reviews of negotiated construction contracts awarded by the Department of Defense led us to the conclusion that:

1. Sufficient cost or pricing data in support of price proposals were not being obtained.
2. Cost analyses of price proposals were not made as required by regulation.
3. Prescribed procedures for utilizing advisory audits were not being followed.

The main reason why the agencies responsible for awarding construction contracts were not complying with the regulation appeared to be their belief that the requirements were not applicable to construction contracts since contractors' price proposals were being evaluated on the basis of comparisons with the agencies' own cost estimates. Primary reliance was placed on such comparisons as a means of evaluating the reasonableness of prices.

We have been informed by the Department of Defense that the agencies now recognize that the law does apply to construction contracts and concur in the necessity of obtaining cost or pricing data where appropriate.

## GSA Construction Contracts

In a review of a number of construction contracts administered by the Public Buildings Service, General Services Administration, we noted some instances where cost or pricing data was not being obtained for individual contract modifications exceeding \$100,000 in amount as required by the Federal Procurement Regulations. Further, the contracts

**did not include the prescribed defective-pricing-data clause.**

Failing to find fulfillment of these requirements in the contracts we reviewed, we sent a letter in July 1967 to the Commissioner, Public Buildings Service, and requested his comments concerning this matter.

We have since received assurances from the Commissioner that General Services Administration internal procurement regulations would be revised to require appropriate clauses to be inserted in various types of construction contracts.

#### Training of Procurement Personnel

Officials of both DOD and GAO recognize that changes in regulations, in themselves, will not be effective unless agency procurement personnel receive additional training in implementing the regulations. To this end, we have worked with the Department of Defense and have mutually agreed on material to be used in training programs for defense procurement personnel illustrating adequate compliance with defense regulations implementing Public Law 87-653. In this connection a training film has been produced by DOD and shown to numerous defense personnel. Also, a sample case, illustrating adequate compliance, has been published in a Defense Procurement Circular for the information and guidance of all procurement and contractor personnel involved in price negotiations.

In addition, DOD procurement teams are currently reviewing practices of procurement officials to ascertain whether these regulations are understood, are complied with, or need further clarification.

#### Matters for Further Consideration

Certain other matters remain open and require additional consideration before final decisions are made.

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These matters involve:

1. Defense criteria for making determinations that price competition, adequate to assure a reasonable price, exists for complex military work, where the work cannot be clearly defined.
2. Additional guidance to contracting officials on obtaining and verifying information to support exemptions from the requirement to furnish cost or pricing data on the ground that proposed prices are based on established catalog or market prices of commercial items sold in substantial quantities to the general public.
3. Clearer definition of the Government's right to price reductions under firm fixed-price contracts where prices are increased because subcontractors have submitted defective cost or pricing data.

## MILITARY SUPPLY SYSTEMS

During the past 18 months, we have assigned a large number of our staff to surveys, studies and reviews of the military supply systems and their responsiveness to military needs.

Primary emphasis has been, and is being, placed on appraising the effectiveness and economy of the supply systems and concurrently identifying and advising military officials of opportunities for improving supply management.

During the period from June 1966 through December 1966, we made a review of the responsiveness of the military supply systems to increased demands generated by the Southeast Asia conflict. We are currently complementing this initial effort with a review of certain aspects of the Army's supply system in Vietnam.

During this Committee's hearings held in May 1967, we apprised you of the results of our review of the supply systems in the Far East. This effort, conducted in cooperation with the Department of Defense, resulted in the identification of 82 specific opportunities for improvements in the operations of the individual military supply systems. The effort also identified several broad problem areas requiring high level management attention.

Subsequent to the May 1967 hearings, we have had the opportunity to observe the results of the military services' actions to accomplish improvements in the areas cited. We were pleased and impressed with the results to date.

For example, with respect to the operation of the Army stock fund, we find that procedures have been changed so that units in combat zones

no longer need concern themselves with stock fund limitations when ordering supplies and equipment. The fund controls inherent in a stock fund system are being applied at a higher level.

In the area of communications, progress has been made in improving the reliability and accuracy of the communications systems used to transmit requisitions and other logistical data. Automatic transmission and switching facilities have been installed at various locations in the Far East and transceiver capabilities have been increased throughout Vietnam. The services have also improved their systems for reconciling and controlling data transmitted.

We are continuing to keep abreast of developments with respect to the various major problem areas we described to you in May.

#### Army's Logistics Structure

One of the more significant areas discussed with you in May involves the Army's Logistics structure.

In our reviews of the military supply systems we observed that it tends to fragment supply management responsibilities through all echelons of command. In this regard, we are of the opinion that improvements are needed in order to more effectively and economically support military operations.

In addition to Headquarters, Department of the Army, all of the Army commands in the continental United States as well as overseas are involved in logistics management and/or planning. The Army Materiel Command has control of stocks only in the depots in the United States. When supplies are issued to the various posts in the United States, the

Continental Army Command assumes responsibility. When supplies are issued to overseas theaters, the overseas commands, such as United States Army, Pacific, or the United States Army, Europe, assume responsibility. The Seventh Army, under the United States Army, Europe, also has a separate depot complex and supply control point.

We found that major problems inherent in such a logistics structure were:

1. The absence of a reliable asset reporting and control system.
2. A variety of data processing systems for logistics management and a concurrent shortage of skilled data processing personnel.
3. Absence of a focal point for worldwide control of supply transactions.

We made a number of proposals to the Army for improving supply responsiveness. One was the establishment of a comprehensive reporting system designed to furnish Army Materiel Command inventory managers with worldwide asset data. We made a similar recommendation in our report to the Congress in April 1967 on the availability of selected stocks in Europe to meet the requirements of other commands within the Department of the Army. In this connection, the Department of Defense informed us in June 1967 that the Department was instituting a system whereby certain Army overseas depot assets will be incorporated in their entirety in the records of the inventory managers in the United States.

The Army has various other programs underway to effect improvements in its logistical organization. Earlier this month the Army briefed us

on its most recent plan for restructuring the Army logistics organization, particularly in the European Theater. In essence, this plan is designed to streamline the organization by eliminating unnecessary levels of inventory management and storage, thereby making for a more direct line of support from using activities to Theater depots. The plan for Europe is to be compatible in format and concept to the logistics organizations and procedures being developed for application in the continental United States as well as in other theaters.

We will follow the progress being made in the implementation of these plans to evaluate the effectiveness of supply operations under the new concepts.

#### Army's Supply Activities in Vietnam

In September 1967 we started a review of Army supply activities in Vietnam to complement the work we did last year. Based on our work to date, the Army's supply system in Vietnam appears to be responsive to the needs of the units supported in terms of providing, on a timely basis, the supplies and equipment necessary to accomplish their missions. This responsiveness has been achieved despite adverse conditions in Vietnam, by using special techniques not contemplated in the normal Army supply system. We recognize that special measures taken during the buildup possibly were necessary; however, we believe that current conditions as described below dictate greater attention to effective management to maintain the proper degree of supply support at a lower cost.

The Army is not yet in a position to know, within a reasonable degree of confidence, what stocks are on hand and what stocks are actually excess to their needs. Generally, military officials at various levels

are aware of these problems and various projects or programs to alleviate the conditions are being undertaken or planned. We are of the opinion, however, that the economic and supply system benefits involved warrant continuing emphasis and attention at all levels.

Our tentative observations of the principal matters which warrant additional management attention and application of resources are:

1. The identification and prompt redistribution of the large number of excess items in Vietnam. The Army in Vietnam believes, on the basis of admittedly unreliable records, that significant quantities of supplies on hand are excess to established stockage objectives.
2. The establishment of accurate data on stocks on hand and consumed, to facilitate sound determinations of needs and consequently avoid accumulation of further excesses.
3. The application of additional supply discipline to reduce to a minimum the use of system disturbing high-priority requisitions.
4. The development of controlled programs which will insure the return of repairable components to the supply system.
5. The establishment of an effective program in Vietnam to insure a maximum degree of inter- and intra-service utilization of supplies.

We are keeping Army officials in the Pacific advised of our findings and observations during the course of our review, and actions are being taken either to correct or study the indicated problem areas. In addition, we have recently briefed DOD officials in Washington on our observations and tentative findings to date so that appropriate attention can be given them at that level. Our review is scheduled for completion in December 1967 and a draft report will be submitted shortly thereafter to the Department of Defense for its comments.

CONTROL OVER GOVERNMENT-OWNED PROPERTY  
IN THE POSSESSION OF DEFENSE CONTRACTORS

At your Subcommittee's hearings earlier this year, limited discussion was held on the subject of control over Government-owned property in the possession of contractors. Our review, which was done at your Subcommittee's request, covered several property classes. The total value of such property is unknown, but available DOD data shows it amounts to about \$11 billion in two major classes.

Since your May hearing, DOD has had an opportunity to comment on our observations and our report was issued to the Congress on November 24, 1967. In general, the Secretary of Defense was receptive to our suggestions. Actions have been taken or planned in response to the majority of our proposals which, if properly implemented, should result in significant improvements in the control and utilization of such property.

Briefly, our findings were as follows:

1. Some of the equipment was being used by contractors in their commercial operations without appropriate Government approval and without, in our opinion, equitable compensation to the Government.
2. There was little or no use for extended periods of a portion of the equipment, for some of which there was a current need in other plants.
3. Utilization data maintained by some contractors was not adequate to indicate the extent and manner of its use.
4. The Defense Industrial Plant Equipment Center, the Office responsible for the management of idle industrial plant equipment, permitted the purchase of equipment without screening to determine whether similar equipment was idle and available at other locations.

5. Rental policies, in some cases, were detrimental to the Government's interests, in that various bases upon which rental payments were negotiated resulted in a lack of uniformity in the rates actually charged, inequities between contractors, and, in some cases, reduced rent payments to the Government.
6. In some cases, it was our opinion that the Government's interests would have been better served by foregoing the replacement of outworn or outmoded equipment in favor of the contractors' acquiring new equipment at their own expense.

In the other categories of property -- special tooling and test equipment, and material -- weaknesses in the control of this property existed due to the absence of financial controls and lack of independence in the taking of inventories by contractors. Also, greater care is needed to properly classify tooling and test equipment since some items have multi-use characteristics and should be classified as facility-type items.

At nonprofit institutions we observed similar discrepancies in property controls. Financial controls were not maintained for facility-type items of industrial plant equipment. Equipment of the type controlled by the Defense Industrial Plant Equipment Center was being donated to universities without screening the Center's records to see if like equipment was needed at other locations.

A further weakness is that the Government's approval of contractors' property accounting systems is of questionable value since contractor systems are allowed to continue in an approved status even though the Government property administrator had identified significant

weaknesses. Also, DOD had made an inadequate number of internal audits regarding the effectiveness of property administration at contractor plants.

As stated earlier, the Secretary of Defense was, for the most part, receptive to our suggestions. However, full concurrence was not expressed by the DOD with respect to:

1. Requiring contractors to furnish machine-by-machine utilization data and to obtain prior Office of Emergency Planning approval on an item-by-item basis for the commercial use of industrial plant equipment.
2. Strengthening the controls over special tooling and special test equipment through the use of financial accounting controls.

We believe that implementation of these proposals or other acceptable alternatives is necessary to effectively administer this property. The Armed Services Procurement Regulation Committee has several alternative proposals under consideration which are directed to the same problem. We will evaluate and make recommendations to the Department on these proposals as they are submitted to us for comment.

## CONTRACTS VS. IN-HOUSE METHODS OF ACQUIRING GOODS AND SERVICES

Earlier this year we advised your subcommittee that we were reviewing the area of contractor versus in-house methods of acquiring goods and services to meet the Government's needs.

The Bureau of the Budget revised Circular No. A-76 effective October 2, 1967, to incorporate some of the changes recommended by the General Accounting Office and other interested Government agencies. There was no change in the Government's general policy, which is to rely upon private enterprise to supply its needs, except under specific conditions, where it is determined to be in the national interest to provide directly the products and services it uses.

The Circular has been modified to clarify the fact that the ten percent cost differential in favor of private enterprise is not intended to be a fixed figure. The differential may be more or less than ten percent, depending upon the circumstances in each individual case.

The revision did not incorporate the recommendation of the General Accounting Office that a separate section or a separate circular set forth specific criteria for application of the policy in the support service contract area. We feel that such policy guidance is needed. Our position is supported by what we have found in our reviews of support service contracts which I will discuss, shortly. The Bureau of the Budget has stated that it intends to give special attention to the adequacies of the guidelines contained in the Circular in this regard.

The revision further did not incorporate the recommendation of several Government officials that state and local taxes should be shown in cost comparisons as costs of Government products and services.

The Defense Department is currently revising its DOD Instruction No. 4100.33, which governs military operation of commercial or industrial activities, to reflect the changes in the Circular and other provisions desired by the Department.

Our work in support services contracts in the Department of Defense and the National Aeronautics and Space Administration indicates that it is often less costly if services are performed by Civil Service employees than by contract employees. The indicated savings are attributable, for the most part, to the elimination of many contractor supervisory and administrative personnel and the elimination of the fees paid to the contractor. For example, our review at the National Aeronautics and Space Administration's Goddard and Marshall Space Flight Centers showed that estimated annual savings of as much as \$5.3 million could be achieved with respect to the contracts we review if these services were performed by Civil Service employees.

Although recognizing that we gave consideration to factors other than cost -- such as the rapid build-up of NASA's program in the early years -- in presenting our conclusions, the Associate Administrator for Organization and Management, NASA, stated that, in the situations discussed in our report, such factors supported the Space Administration's decisions that contracting for the services involved had been in the best interests of the Government.

We believe that, in contrast to its past rate of growth, the Space Administration has now achieved a relative degree of stability

and should be able to better consider relative costs in assessing the extent to which it should continue to rely on the use of support service contracts. In this regard the Associate Administrator advised us that the Space Administration recognized the need for more specific guidance on cost considerations and that such guidance would be part of any redefinition of policy resulting from a current review of agency experience in the use of support service contracts.

Although NASA had planned to increase its expenditures for support service contracts in Fiscal Year 1968, we have been advised by the agency that final decisions in this area have had to be deferred pending the outcome of its appropriation bill. Also, NASA has been studying the entire support service area over the last several months and the results of this study, according to the agency, may well affect its future plans.

We have recently received a copy of the October 1967 Opinion of the General Counsel of the Civil Service Commission regarding the legality of selected contracts at Goddard Space Flight Center, National Aeronautics and Space Administration. It seems evident that this document will be of significant value to agencies in ascertaining the propriety of technical support, or similar service contracts.

As such matters come to our attention during audit activities, we will continue to consult with representatives of the Commission regarding technical support service and similar contracts which appear questionable in the light of the standards set forth in the Opinion.

## Lease versus purchase of facilities by contractors

Government contractors frequently rely on other private enterprises for furnishing, under lease agreements, land and buildings for use in performing Government contracts.

We have performed a review at 20 locations of 17 major contractors for the purpose of ascertaining the effect on costs to the Government of the practice by contractors of leasing land and buildings to be used extensively in the performance of Government contracts. The sales to the Government resulting from contractor operations at these 20 locations amounted to about \$4.2 billion in 1966.

In this review we compared the costs to the Government resulting from the contractors' leasing arrangements with the estimated cost the Government would have incurred if the contractors had owned the land and buildings. In making these comparisons, we used property values based on actual costs, sales prices, appraisals, or other related data obtained from the contractors or local taxing authorities.

We identified 63 leasing agreements which committed the contractors to pay rentals of about \$95.2 million during the initial lease periods for land and buildings. We found from our review of these leasing agreements that in every case but one, leasing was more costly to the Government during the periods of the initial leasing.

The leases involved were executed during the period from 1952 to 1967 and provided for the use of the facilities for periods ranging from 2 to 25 years and included renewal option periods to extend occupancy. If the facilities had been contractor owned, depreciation charges would have amounted to about \$35.7 million or about \$59.6 million.

less than the rental costs. Based on 1966 sales, the Government's share of the difference could amount to about \$57.7 million.

The following is an example of what we found in this review.

In 1958, the contractor involved began leasing land and buildings at three locations for the performance of Government contracts. By the end of 1963, the leased land and buildings at these locations consisted of about 340 acres of land and more than 890,000 square feet of building space which had been acquired by the lessors at an estimated cost of \$21.2 million.

Under the terms of the leases which were for 20 and 25 years, the contractor's fixed rental costs will be about \$34.1 million, or 160 percent of the estimated acquisition cost. We estimated depreciation on the buildings to be about \$15 million, or \$19 million less than the rental charges. The Government's share of the rentals in excess of depreciation will be about \$18.1 million.

At two of the three locations, we found that the contractor either had owned, or had possessed a contractual right to purchase the land

upon which the leased facilities were ultimately erected, but had sold or transferred its rights to the land to the lessors immediately prior to the construction. The buildings were erected according to the contractor's specifications or renovated to meet its requirements.

In addition to the fixed annual rentals, the contractor obligated itself to provide maintenance and insurance protection and to pay all real estate taxes and assessments. Since the contractor assumed the obligations normally associated with ownership of real property, it appears that the principal function performed by the lessors was to finance the construction of the facilities.

We believe that the Armed Services Procurement Regulation encourages contractors to lease facilities. Contractors who lease their facilities and contractors who purchase their facilities receive the same fees under profit guidelines in the regulation. On the other hand, a contractor that utilizes Government facilities may be penalized by a reduction in the rate of profit of up to 2 percent. Further, the ASPR does not allow reimbursement of interest costs for borrowed capital if the contractor decides to acquire real property through purchase rather than lease.

It is our view, therefore, that the contractor which purchases its facilities contributes more to the performance of Government contracts than the contractor that leases such property and that this should be recognized in contract negotiations.

We believe the Armed Services Procurement Regulation should be revised to distinguish between owned and leased facilities in establishing profits or fees. We previously made a report on long-term leasing of

buildings and land by another Government contractor. In reply to our report we were advised that the Department's Armed Services Procurement Regulation Committee has been asked to review the rental cost principle particularly as it relates to long-term noncancellable leases. Our current review, we believe, offers further substantial evidence of the need for revising the Department of Defense regulation.

Accordingly, in a recent draft report we have recommended that action be taken to promptly complete this review by the Armed Services Procurement Committee and to reach a conclusion on this matter. We have not yet received the Department's comments.

### SMALL PURCHASES

On August 3, 1967, in hearings before the Subcommittee for Special Investigations, House Committee on Armed Services we stated that present and future plans for our procurement work included reviews of procurement systems - small purchases. At about the same time a member of that subcommittee, Congressman Pike, requested our assistance in determining the reasonableness of prices paid for a number of small purchases by Department of Defense procurement offices.

In view of the above congressional interest an examination into the reasonableness of prices paid by selected Department of Defense procurement offices was given top priority for our initial work in the area of small purchases.

In addition, because of the attention drawn to this area, the Assistant Secretary of Defense (Installations and Logistics) on August 18, 1967, requested that the Army, Navy, Air Force, and Defense Supply Agency appraise the adequacy of performance in the small purchase area by reviewing the staffing, training, supervision, and accomplishment of daily tasks. He requested that the appraisals be accomplished within 60 days and that a summary of the results including action taken or planned be submitted to him.

The summary report submitted by the Defense Supply Agency pointed out that the Agency has several problems in the small purchase area, most prominent of which are: (a) lack of descriptive data concerning items

to be procured as small purchases, (b) need for training of procurement personnel who handle small purchases, and (c) need for improved supervision and review of buyers' actions.

The Agency has taken or plans to take action to obtain better data, to increase training, and to improve supervision and review. Other actions are being considered. We have not yet had the opportunity to review the reports submitted to the Assistant Secretary by the Army, Navy, and Air Force.

At the present time we are working with agency representatives who made these appraisals. We are reviewing the cases considered, including their findings, and actions being taken to correct the deficiencies disclosed.

We have examined a sufficient number of individual cases to assure ourselves that a need exists for improvements in establishing the reasonableness of prices to be paid for small purchases. We believe that by the early part of next year we will have completed our tests of the work performed by the military services, reviewed the actions that they have taken or plan to take, and be in a position to reach a conclusion as to what further actions are appropriate.

In addition, we intend to apply our resources to overall reviews of purchasing systems for small purchases. These reviews will include (a) size and frequency of buys, (b) automation of procedures, (c) paper work routines, and (d) their effect on administrative lead time and each other.