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Report to the Commander, Naval Sea Systems Command

February 1987

CONTRACT PRICING

Material Prices Overstated on Standard Missile and Phalanx Systems

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General Accounting Office
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February 11, 1987

Vice Admiral William H. Rowden
Commander, Naval Sea Systems Command
Department of the Navy
Washington, D.C. 20362

Dear Admiral Rowden:

As part of a nationwide review of contract pricing at 10 Department of Defense (DOD) contractor locations, we reviewed subcontract pricing at General Dynamics Corporation, Pomona Division, Pomona, California. We examined subcontract prices on the following five prime contracts for the production of the Standard Missile and the Phalanx weapon system.

N00024-83-C-5505—Standard Missile I
N00024-83-C-5515—Standard Missile II
N00024-83-C-7040—Phalanx weapon system
N00024-84-C-5500—Standard Missile I
N00024-84-C-7000—Phalanx weapon system

Our objective was to determine whether General Dynamics complied with Public Law 87-653, the Truth in Negotiations Act, in providing accurate, complete, and current cost or pricing data. We also assessed whether DOD contracting officers implemented subcontract pricing requirements designed to ensure the negotiation of fair and reasonable prices.

We found that the five contracts were overpriced by about $1.9 million because General Dynamics did not disclose, prior to reaching price agreement with the government, the most accurate, complete, and current subcontract cost or pricing data for 14 of the 66 subcontract items we reviewed. In addition, Navy contracting officers did not obtain evaluations from General Dynamics on 21 of 23 major noncompetitive subcontract price proposals for use in prime contract negotiations, as required by regulations

We believe the results of our review provide a basis for your initiating action to obtain recovery of funds from General Dynamics and we recommend you take such recovery action Details on our work are presented in appendix I

Copies of this report are being sent to the Vice President and General Manager of General Dynamics, Pomona Division, Pomona, California; the DOD Office of the Inspector General, Washington, D.C.; the Regional Director, Defense Contract Audit Agency, Los Angeles, California; and the Naval Plant Representative at General Dynamics, Pomona, California.

Sincerely yours,

George E. Grant

George E. Grant
Regional Manager

Review of Selected Aspects of Subcontract Pricing Under Navy Prime Contracts With General Dynamics, Pomona Division

Background

Public Law 87-653, as amended, requires that, with certain exceptions, contractors submit cost or pricing data in support of proposed prices for noncompetitive contracts Contractors are required to certify that data submitted are accurate, complete, and current. A clause is also included in the contract which provides for a price reduction if it is determined that the price was overstated because the data submitted were not accurate, complete, and current

The Federal Acquisition Regulation (FAR) provides that government contracting officers require prime contractors to obtain and submit prospective[1] subcontract cost or pricing data in support of each subcontract cost estimate that is $1 million or more, or that is both more than $100,000 and more than 10 percent of the proposed prime contract price FAR also provides that the prime contractor is responsible for the review and evaluation of prospective subcontract cost or pricing data, and for submission of the evaluation results to the government contracting officer as part of the prime contractor's cost or pricing data submission.

Nondisclosure of More Current Subcontract Pricing Information

Naval Sea Systems Command (NAVSEA) contract prices were overstated by approximately $1 9 million, including overhead and profit, because General Dynamics did not disclose more accurate, complete, and current pricing information before the conclusion of prime contract negotiations for 14 of the 66 subcontract cost estimates.

The overstated prices are summarized in table I.1.

[1]Prospectively priced subcontracts are those that are not priced at the time prime contract negotiations are concluded

Table I.1: Schedule of General Dynamics Overstated Subcontract Item Prices

Part number	Nomenclature	Unit price: Disclosed	Unit price: Not disclosed	Quantity	Extended price difference	Contract overhead and profit	Total overstatement
Prime contract N00024-83-C-5505							
3253402	Antenna	$1,935	$1,637	781	$232,738		
5246996	Accelerometer	1,236	1,170	1,562	103,092		
Total					**335,830**	**$165,702**	**$501,532**
Prime contract N00024-83-C-5515							
2917888	Battery	5,285	4,794	323	158,593		
3164232	Torque motor	649	559	646	58,140		
3252750	Oscillator	1,864	1,745	323	38,437		
3253402	Antenna	1,935	1,637	323	96,254		
5245763-001	Amplifier	7,522	6,000	96	146,112		
5246164	Amplifier	11,008	11,300	96	(28,032)		
3280565	Gyro	1,163	1,299	646	(87,856)		
Total					**381,648**	**201,090**	**582,738**
Prime contract N00024-83-C-7040							
5186629	Servo motor	3,150	2,786	335	121,940		
5262863	Tape drive	7,031	6,913	101	11,918		
Total					**133,858**	**56,427**	**190,285**
Prime contract N00024-84-C-5500							
3164917	Torque motor	384[a]	312	3,356	241,632		
5246996	Accelerometer	1,290[a]	1,198	1,632	150,144		
Total					**391,776**	**183,483**	**575,259**
Prime contract N00024-84-C-7000							
5190630	Switching module	14,947	14,071	53	46,428	**13,496**	**59,924**
Total					**$1,289,540**	**$620,198**	**$1,909,738**

[a]These represent the amounts considered negotiated in the prime contract price

The problems we found in our review of these contracts are illustrated below.

Contract N00024-83-C-5505

Two subcontract cost estimates were overstated by $335,830, or $501,532, including overhead and profit. To illustrate, an antenna, part number 3253402, was proposed at a weighted average unit price of $1,935, based on September 1982 price quotations of $1,610 and $2,043 from two suppliers General Dynamics intended to dual source the item on a 25/75 percent split arrangement.

On June 14 and 23, 1983, revised lower price quotations were submitted by the prospective suppliers at $1,425 and $1,849 a unit. On May 5, 1983, in a request for cost analysis, the General Dynamics buyer indicated that the item would be procured on a 50/50 percent split arrangement. Using the revised lower price quotations, the resulting weighted average unit price of $1,637 was the most current pricing information available before prime contract negotiations were completed on July 28, 1983. Nondisclosure of the revised lower price quotations resulted in an overstatement of $298 a unit, or $232,738 for the contract requirements of 781 units.

Contract N00024-83-C-5515

Five subcontract cost estimates were overstated and two were understated, for a net overstatement of $381,648, or $582,738, including overhead and profit To illustrate, an amplifier, part number 5245763-001, was proposed at $7,522 a unit, based on a sole-source subcontract price proposal dated January 31, 1983. On July 22, 1983, General Dynamics negotiated a unit price of $6,000 with the sole-source subcontractor Nondisclosure of the lower negotiated subcontract price before prime contract negotiations were completed on September 9, 1983, resulted in an overstatement of $1,522 a unit, or $146,112 for the contract requirements of 96 units

One of the two cost estimates which were understated was for a gyro, part number 3280565 This part was proposed under a 57/43 percent split buy for a weighted average unit price of $1,163, based on an April 1983 price quotation of $1,218 a unit and the results of negotiation with a second supplier at $1,090 a unit On August 17, 1983, however, the April quotation was revised to $1,459. The weighted average unit price for the intended split buy was $1,299, or $136 a unit, higher than what was proposed by General Dynamics. Nondisclosure of the revised higher price proposal resulted in an understatement of $87,856 for the contract requirements of 646 units.

Contract N00024-83-C-7040

Two subcontract cost estimates were overstated by $133,858, or $190,285, including overhead and profit To illustrate, a servo motor, part number 5186629, was proposed at $3,150 a unit, based on a sole-source price proposal dated January 4, 1983.

On July 21, 1983, the sole-source supplier submitted a revised lower price proposal of $2,966 In addition, a viable second supplier also submitted a price proposal of $2,246 a unit. The weighted average unit

price based on a contemplated 75/25 percent split buy was $2,786. Nondisclosure of the lower price proposals available before completing prime contract negotiations on September 23, 1983, resulted in an overstatement of $364 a unit, or $121,940 for the contract requirements of 335 units.

Contract N00024-84-C-5500

Two subcontract cost estimates were overstated by $391,776, or $575,259, including overhead and profit. To illustrate, a torque motor, part number 3164917, was proposed at a weighted average unit price of $390, based on price quotations of $487 and $325 from two suppliers. General Dynamics intended to dual source the item on a 60/40 percent split arrangement.

General Dynamics had option prices of $357 and $285 a unit from an existing purchase order for about 80 percent of the contract requirements. The option prices were with the same supplier that had submitted the price quotation of $487 a unit In addition, General Dynamics negotiated a slightly lower unit price of $320 on June 29, 1984, with the second supplier that had quoted the $325 unit price The weighted average of the option prices and the more recent negotiations was about $312 a unit, or $78 less than what was proposed by General Dynamics Pricing concessions achieved by the NAVSEA contracting officer in prime contract negotiations reduced the unit price difference to $72. Nondisclosure of the more current pricing information available before prime contract negotiations were completed on July 30, 1984, resulted in an overstatement of $241,632 for the contract requirements of 3,356 units.

Contract N00024-84-C-7000

One subcontract cost estimate was overstated by $46,428, or $59,924, including overhead and profit. This subcontract covered a gun mount and related subsystems which were proposed at $302,000 a unit, based on negotiations between General Dynamics and a sole-source supplier on August 28, 1984, before completing prime contract negotiations on December 18, 1984. A switching module, part number 5190630, was one of six subsystems that comprised the gun mount. The negotiated unit price of the switching module was $14,947 of the system unit price of $302,000.

While General Dynamics disclosed the negotiated system unit price of $302,000, including the switching module unit price of $14,947, the company did not disclose that 53 of the 81 switching modules for the contract had been acquired on June 5, 1984, at $14,071 a unit.

Nondisclosure of the lower unit price resulted in an overstatement of $46,428.

Noncompliance With Requirements to Perform and Submit Subcontract Price Proposal Evaluations to Navy Contracting Officers

FAR 15.806(a) requires contractors to review and evaluate prospective subcontract cost or pricing data submitted in support of proposed prices, and furnish the results of such reviews and evaluations to the government contracting officer as part of the prime contractor's cost or pricing data submission. This provision is mandatory for subcontract cost estimates over $1 million, or when the cost estimate is both over $100,000 and more than 10 percent of the proposed prime contract price.

NAVSEA and Naval Plant Representative Office (NAVPRO) contracting officers did not ensure that General Dynamics complied with these subcontract pricing requirements, and most of the subcontract proposal evaluations made by General Dynamics were not disclosed to the contracting officers for the five prime contracts we reviewed. In some cases, the proposal evaluations were not completed until after prime contract negotiations.

General Dynamics evaluated 23 subcontract cost estimates over $1 million each, amounting to $102.9 million. Price negotiations between the subcontractors and General Dynamics had not been completed at the time of prime contract negotiations for eight of the estimates. General Dynamics completed three of the proposal evaluations before and five evaluations after the conclusion of prime contract price negotiations None of the evaluations were disclosed to the government. General Dynamics also evaluated an additional 15 subcontract cost estimates before the conclusion of prime contract negotiations, but only disclosed 2 evaluations to the NAVSEA contracting officers. These 15 evaluations were used to negotiate lower prices with the subcontractors before prime contract negotiations. In most cases, the lower negotiated prices were disclosed to the government and, thus, mitigated the potential adverse effect of not disclosing the proposal evaluations.

General Dynamics negotiated $1,627,000 in lower prices with its subcontractors than what NAVSEA contracting officers were able to achieve in prime contract negotiations for the eight prospectively priced subcontract cost estimates of $45.8 million. The lower negotiated subcontract prices were due to a number of factors, one of which was General Dynamics' use of subcontract price proposal evaluation results.

NAVSEA contracting officers used various pricing techniques as substitutes for subcontract price proposal evaluations, such as decrement (decrease) factors, price analysis, and escalation of prior material prices. For example, on contract -5505, the contracting officer decreased material cost estimates for unpriced orders over $100,000 by 4.7 percent based on the percentage reduction achieved by General Dynamics on orders placed in anticipation of getting the contract. A similar technique was used for contract -5515, which yielded a 4.8 percent decrease. For contract -5500, the contracting officer used pricing history and an improvement curve technique to establish the negotiation objective. While these techniques generally aided the contracting officers in negotiating lower prime contract prices, they were not adequate substitutes for subcontract price proposal evaluations.

During our review, General Dynamics did not have written guidance implementing the FAR 15.806(a) requirements for submitting the results of subcontract proposal evaluations to DOD contracting officers before prime contract negotiations. In addition, the lack of procedural guidance and related implementation of the FAR requirement had not been identified previously by NAVPRO or the Defense Contract Audit Agency (DCAA) during contract pricing and cost estimating system reviews

After we brought this matter to the attention of the contractor, NAVPRO, and DCAA personnel, General Dynamics revised its procurement department instructions to provide for the tracking of price proposal submissions and related subcontract proposal evaluations, and for the submission of the written analyses to the NAVPRO administrative contracting officer. NAVPRO subsequently told General Dynamics on September 27, 1985, of the need to submit a cost/price analysis for use in prime contract price proposal evaluations and stressed that compliance would be closely monitored.

General Dynamics' implementation of the procurement department instructions should provide the necessary assurances that NAVSEA contracting officers have relevant and timely subcontract price proposal evaluations for use in prime contract negotiations.

Contractor Comments and Views of NAVSEA Officials

General Dynamics stated that at the completion of material negotiations, both parties agreed to a reduction in material costs. According to the company, the reductions were to provide for (1) undisclosed actions which may have had an effect on the price negotiations and (2) changes in vendor prices as quotations were subsequently converted to firm

prices. The reductions amounted to about $2,448,000 and exceeded the amount we questioned for the five contracts. Therefore, General Dynamics believes the overpricing caused by nondisclosures of accurate complete, and current data have been more than offset by "legitimate negotiated reductions."

We agree with General Dynamics that the reductions covered anticipated changes in vendor prices as quotations were converted to firm prices. We do not agree, however, that the reductions covered undisclosed actions that may have had an effect on price negotiations. The NAVSEA contract negotiation records show only that the reductions were to provide for anticipated material price decreases as vendor quotes were subsequently converted to firm prices. The negotiation records and our discussions with the NAVSEA contracting officers do not support General Dynamics' position that the reductions were to cover overpricing caused by nondisclosure of more current cost or pricing data

Our computation of overpricing was based on a comparison of nondisclosed material prices with the prices considered negotiated by the NAVSEA contracting officers. Since the prices considered negotiated already include reductions for anticipated decreases as vendor quotes were converted to firm prices, we have given full consideration to such reductions. Accordingly, we do not believe it is appropriate to use the negotiated reductions claimed by General Dynamics to cover the overpricing we found.

General Dynamics also believes the overstated material prices we found should be offset because a cost estimate for a battery, part number 2638828, was understated in contract -5505 by about $325,000 General Dynamics stated that the battery price was erroneously estimated at $2,811 rather than the more current supplier price proposal of $3,256 a unit.

We agree that a more current price proposal of $3,256 a unit apparently was not disclosed to the NAVSEA contracting officer However, we do not agree that the nondisclosure resulted in an underestimate of the contract price because (1) the NAVSEA contracting officer did not rely on the $2,811 estimate, but instead relied on a January 6, 1983, priced bill of material which included a $3,380 unit cost estimate for the battery decremented by 4.7 percent, (2) the NAVSEA contracting officer was aware of an earlier supplier price proposal of $3,226 a unit, which closely approximated the nondisclosed price of $3,256, and (3) General Dynamics had evaluated the $3,226 unit price proposal before prime

contract negotiations and, in an evaluation report dated June 17, 1983, had established a negotiation range of $2,449 to $2,705 a unit, far less than the claimed offset price of $3,256. The General Dynamics evaluation report was not disclosed to the NAVSEA contracting officer

General Dynamics also stated that the cost estimate for the battery was further understated in contract -5505 by about $135,000, due to the omission of silver costs applicable to 80 units intended for foreign military sales. We agree that the most recent priced bill of material dated July 23, 1983, omitted the silver costs; however, it was not used in prime contract negotiations. The earlier January 6, 1983, priced bill of material which was relied on in prime contract negotiations by the NAVSEA contracting officer, included a cost estimate of $120,000 for silver. The NAVSEA contract negotiation record shows that the price of contract -5505 included $102,000 for silver, based on a recommendation in a DCAA price proposal audit report dated February 8, 1983. Therefore, omitting silver costs from the most recent bill of material did not result in an understatement of the price of the contract.

A NAVSEA contracting official told us that the matter of overstated subcontract cost estimates would be reviewed and appropriate action taken to reduce the contract prices if it were determined that the contract prices were overstated. Concerning the noncompliance with subcontract pricing requirements of FAR 15.806(a), NAVSEA agreed with the conditions cited in the report and stated that steps have been taken to obtain timely subcontract price proposal evaluations on current production contract proposals from General Dynamics.

Objective, Scope, and Methodology

Our overall objective was to determine if subcontract costs included in prime contract prices were fair and reasonable. As part of this effort, we assessed whether General Dynamics complied with Public Law 87-653 in providing accurate, complete, and current cost or pricing data. We also assessed whether DOD contracting officers were effectively implementing subcontract pricing requirements designed to ensure the negotiation of fair and reasonable prime contract prices.

We were particularly interested in whether contracting officers were ensuring that General Dynamics (1) obtained prospective subcontract cost or pricing data, (2) evaluated subcontract price proposals and submitted the results for use in prime contract price negotiations, and (3) disclosed the most accurate, complete, and current subcontract pricing

data before prime contract negotiations. In addition, we wanted to determine if the contracting officers made effective use of the subcontract proposal data and evaluation results in prime contract negotiations.

Information on the pricing of each contract we reviewed is included in table I.2.

Table I.2: Information on the Pricing of NAVSEA Contracts Awarded to General Dynamics, Pomona Division

	Prime contract N00024-				
	83-C-5505	**83-C-5515**	**83-C-7040**	**84-C-5500**	**84-C-7000**
Product	Standard Missile I, Block VI	Standard Missile II, Block I	Phalanx	Standard Missile I, Block VI	Phalanx
Awarded	August 1983	September 1983	September 1983	July 1984	December 1984
Contract type[a]	FFP	FFP	FPI	FFP	FPI
Amount	$110,900,000	$92,000,000	$180,847,000	$117,300,000	$191,567,000
Price proposal					
Initial	August 1982	April 1983	August 1982	August 1983	January 1984
Revised	January 1983	•	•	February 1984	•
Negotiations conducted	May 4 to July 28, 1983	August 30 to September 9, 1983	June 8 to September 23, 1983	May 8 to July 30, 1984	October 15 to December 18, 1984
Pricing certificate executed	August 12, 1983	September 20, 1983	September 30, 1983	August 13, 1984	December 20, 1984

[a]Firm fixed-price (FFP) and fixed-price incentive (FPI)

For the 5 contracts listed in table I 2, we reviewed the pricing of 66 subcontract cost estimates in excess of $500,000. The subcontract cost estimates amounted to $139.5 million.

The scope of our review included General Dynamics' purchasing file documents, such as subcontract price proposals and quotations, cost analyses and proposal evaluation reports, negotiation memorandums, purchase orders, and departmental instructions and procedures. The prime contract file documents we reviewed included priced bills of material, negotiation memorandums, and proposal evaluation reports. The results of our review were discussed with General Dynamics officials as well as NAVSEA contracting officers and NAVPRO and DCAA personnel.

Our review was performed in accordance with generally accepted government auditing standards.

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