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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

JAN 2 - 1970

B-166781

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

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We completed an examination of the validity of exemptions granted Hewlett-Packard Company (H-P), Palo Alto, California, from the Public Law 87-653 requirement for submission of certified cost or pricing data in support of proposed prices. The exemptions were granted on the basis that prices offered were based on catalog or market prices of commercial items sold in substantial quantities to the general public. Our objectives were to determine whether existing regulations were complied with by Government officials in granting the exemptions and whether these regulations provided an adequate basis for determining that proposed prices were fair and reasonable in relation to those offered comparable commercial customers.

Hewlett-Packard was selected for review because it was identified as the predominant Government contractor claiming the catalog exemption. Although our review was restricted to contracts awarded this company, we believe our findings should be of concern to all procurement officials responsible for evaluating contractors' claims for the catalog exemption.

In our review we examined catalog exemptions granted H-P during the period January 1974 through August 1974. Five procurements totaling \$5.1 million were selected at random from 47 Department of Defense (DOD) prime contracts and sub-contracts totaling \$21.2 million awarded H-P during that period. Each contract exceeded \$100,000, and the award was not based on competition. The individual items purchased were evaluated for compliance with the Armed Services Procurement Regulation (ASPR) requirements for catalog exemption.

In summary, we found that contracting officers had not complied with all ASPR requirements for granting catalog exemptions. In most cases the contractor was not required by contracting officers to submit a formal claim for exemption. When exemption claims were submitted, supporting data

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was frequently incomplete, inaccurate, and noncurrent and in some cases was not sufficient to demonstrate the commerciality of products. For these reasons we believe the Government did not have adequate assurance that prices paid to H-P for catalog items were fair and reasonable in relation to those paid by comparable customers. We also found that the Defense Contract Audit Agency's (DCAA's) audit reports usually contained information on H-P's standard quantity discounts; however, in no case did DCAA's reports comment on the accuracy of the lowest prices or most comparable sales reported on the catalog exemption claim.

We recommend that you reemphasize to all procurement officials the need to thoroughly analyze contractors' claims for catalog exemption from the requirement for submitting cost or pricing data in support of proposed prices. Special emphasis should be placed on (1) requiring contractors to submit all the necessary data and (2) making an indepth evaluation of all claims for catalog exemption, including audits of sufficient depth and scope to insure that sales data reported is accurate, current, and complete.

We also believe that DOD's position on the (1) period of time for which catalog sales data should be submitted and (2) propriety of H-P's practice of not offering discounted prices to DOD comparable to those available to certain other designated original equipment manufacturer customers should be clarified or reevaluated. Additional details on our review are in the enclosure.

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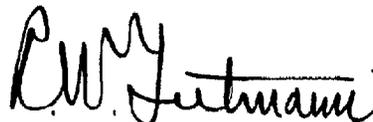
We are sending copies of this letter to the Director, Office of Management and Budget; the Secretaries of the Army, the Navy, and the Air Force; the Director, Defense Supply Agency; and the Director, Defense Contract Audit Agency. We are also sending copies to the Chairmen of the Senate and House Committees on Government Operations, Appropriations, and Armed Services.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

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We would appreciate receiving your comments on these matters and would be pleased to discuss any questions that you may have.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "R. W. Gutmann".

R. W. Gutmann
Director

Enclosure

SUMMARY OF REVIEW
OF THE VALIDITY OF HEWLETT-PACKARD
CLAIMS FOR EXEMPTION FROM SUBMISSION OF COST
OR PRICING DATA

BACKGROUND

Public Law 87-653 and the Armed Services Procurement Regulation (ASPR) provide that, with certain exceptions, contractors be required to submit cost or pricing data in support of proposed prices for noncompetitive contracts and contract modifications expected to exceed \$100,000. In addition, contractors are required to certify at the time of negotiations that data submitted is accurate, complete, and current. An exception permits the award of negotiated contracts without submission of certified cost or pricing data whenever the proposed price is based on established catalog or market prices of commercial items sold in substantial quantities to the general public.

Before June 12, 1972, ASPR provided that for an item to qualify for this exemption (1) the current price of the item must be included in a catalog or on a price list, (2) the item must be used for other than Government purposes, (3) commerciality must be established, and (4) the item must be sold to the public.

On June 12, 1972, ASPR was revised to establish a minimum percent of sales of an item that must be sold to the general public to qualify for exemption as follows:

1. Sales to the general public total at least 35 percent of the total sales.
2. Sales to the general public at published catalog prices represent at least 75 percent of total sales to the general public.

A DD form 633-7 (Claim for Exemption From Submission of Certified Cost or Pricing Data) is required for each catalog item for which an exemption is claimed and the total proposed price is \$10,000 or more. The form requires a contractor to report units sold to the Government and to the general public at catalog prices. In addition, sales information regarding three sales which represent the lowest price at which the item was offered to the

general public is to be reported. Copies of DD form 633-7 are submitted by subcontractors (through intermediate subcontractors if any) to the prime contractor who submit them with the prime contractor's proposal, if not previously submitted to the contracting officer.

DD form 633-7 is designed to obtain information required to permit the contracting officer to determine whether the items qualify for exception to the Public Law 87-653 requirement.

Submission of form 633-7 may be waived for items exempted within the past year. If a prior exemption has been granted, the contractor must advise the contracting officer of any changes in the data contained in the prior submission affecting the exemption or price.

EXEMPTIONS GRANTED WITHOUT REQUIRING
SUBMISSION OF DD FORM 633-7 OR INFORMATION
REQUESTED ON THE FORM

Although the 5 sample procurements we examined included 62 items costing about \$3.5 million for which DD form 633-7's were required, we found forms were filed for only 10 of these items totaling about \$1.8 million. For the remaining 52 items, neither the Hewlett-Packard Company (H-P), the cognizant Government contracting office, nor the prime contractor for which H-P was a subcontractor were able to furnish a copy of the required DD form 633-7.

For example, 12 of the 52 products for which a DD form 633-7 was not found were purchased under a Kelly AFB contract. Cognizant Kelly AFB officials stated the exemptions were granted because a procurement history had been established for the items through prior purchases and the items were listed in a General Services Administration catalog. We were told further that contractors were required to submit a DD form 633-7 only when a product had no procurement history or the contracting officer had reason to suspect the product no longer satisfied ASPR criteria for commerciality. For 5 of the 12 items, we requested information on the most recent DD form 633-7 submission and the last independent verification of the reasonableness of the proposed price and commerciality of the product. The information provided showed that the pricing and commerciality of these products was last reviewed at least a year and a half before the procurements we examined.

H-P officials stated the company's policy was to provide DD form 633-7 information when requested. They stated that when the submission of such information could not be found, it probably was not requested.

MOST DD FORM 633-7'S SUBMITTED BY H-P
CONTAINED NONCURRENT, INACCURATE, OR
INCOMPLETE INFORMATION

We reviewed the adequacy of the data contained on 30 DD form 633-7's submitted by H-P. These included the aforementioned 10 submissions for which an exemption was granted and 20 other submissions.

The data on a majority of the 30 DD form 633-7's was inaccurate, incomplete, and misleading with respect to the percentage of sales of the products to the Government, the prices of the products to the Government, and the prices received on sales to the general public. An audit of the contractor's supporting data was not adequate to disclose the erroneous information reported on the DD form 633-7's.

Sales data reported was noncurrent and/or
for unrepresentative periods

H-P's recordkeeping system accumulates data on product sales to the Government and commercial customers on a quarterly basis in a computer-generated "commerciality report." We compared the sales data reported on the 30 DD form 633-7's in our sample with sales data for the most recent 1-year period before contract negotiations.

We found that the sales data reported for more than half of the 30 form 633-7's evaluated was noncurrent and/or unrepresentative. For example, 11 of the 30 DD form 633-7's did not disclose the most recent data available as required. In 2 of the 11 submissions, the sales data reported was for a period ending 18 months preceding the date of negotiations. In 4 of the 11 submissions, sales data from the most recent 1-year period showed that non-Government sales were from 7 to 47 percent lower than reported in the H-P submission, and 2 of these 4 submissions did not satisfy the minimum ASPR criteria of 35 percent commercial sales for catalog exemption. For the seven other products, non-Government sales were from 0 to 22 percent higher than the percentage reported in the H-P submission.

The sales data reported on 19 of the 30 DD form 633-7's covered 3 months or less. A review of sales data for the 1-year period before contract negotiations showed that, in 10 of the 19 submissions, the percentage in the commerciality report varied more than 10 percent from that disclosed in the H-P submission.

In four instances, the sales data for the longer period reflected a percentage of commercial sales from 16 to 33 percent below that reported in the H-P submission. In one of these four submissions, the percentage for the 1-year period failed to satisfy the minimum ASPR criteria for granting a catalog exemption.

Disclosure of incorrect information on
lowest prices and comparable quantity sales

We checked the prices reported on the DD form 633-7's for 8 of the 30 products to sales for the year before the Government's purchase. Although the prices reported generally were representative of the majority of H-P's domestic sales, there were sales at lower discounted prices.

For five of these eight products, H-P sales records reflected instances of lower prices than those reported on the applicable DD form 633-7, and H-P was unable to adequately justify the nondisclosure. For three of four products for which no price discounts were reported on the applicable DD form 633-7, we noted the best discounts given were 3 to 5 percent. For the fourth product, the discount given on the only two recent sales was 30 percent below the unit price H-P listed on the DD form 633-7. For the fifth product, a 4-percent price discount was reported, but the best discount actually given was 5 percent. Although price discounts were given infrequently, we believe they should have been disclosed on the DD form 633-7 to insure fairness in negotiation of prices.

Detailed H-P sales records also disclosed that for three of the eight products we tested, the most comparable quantity commercial sale was not disclosed on the DD form 633-7. For 1 product we noted 49 separate unreported sales of quantities more comparable to the Government's purchase, and in another instance 20 such sales were noted. We believe that, although reporting the more comparable quantity sale would not necessarily change the amount of the lowest prices disclosed, disclosure of the most comparable quantity sale would assist the Government contracting officer in ascertaining the propriety of an exemption claim.

Audit coverage at Hewlett-Packard

For 29 of the 30 exemption claims we reviewed at H-P, the Defense Contract Audit Agency (DCAA) audited the information H-P provided concerning the percentage of sales to commercial customers and evaluated whether commercial sales were made in substantial quantities as required by ASPR. Although DCAA's audit reports usually contained information on H-P's standard quantity discounts, in no case did DCAA's reports comment on the accuracy of the lowest prices or most comparable sales reported on the catalog exemption claim.

The cognizant DCAA auditor told us that whenever DCAA was requested to evaluate a DD form 633-7 submission from H-P, it attempted to validate all the information. This was limited, however, by the time frame established for making the evaluation and the availability of the necessary records at H-P. We were told further that as a practical matter the information H-P provided relative to the lowest priced sale to a commercial customer and the most comparable sales to commercial customers was generally not validated because supporting detailed sales records such as customer purchase orders and H-P invoices were kept on a decentralized basis at the sales offices.

COMMERCIALITY OF PRODUCTS NOT ESTABLISHEDCatalog exemption granted for product never sold to general public

During our review, we noted one instance in which a contracting officer granted H-P a catalog exemption from cost or pricing data even though the item procured was a modified version of a new product which had not yet been sold to the general public. At the time the \$2.8 million contract was awarded, the unmodified version of the new product was still in the developmental stage and had not yet been produced. Despite the failure to satisfy ASPR requirements, the Navy granted H-P's request for an exemption.

In response to Navy's request, H-P submitted a proposal totaling \$3,568,555, including catalog items of \$2,846,432. DCAA was requested to analyze only the noncatalog part of the proposal. The quantity of units requested was subsequently reduced, the catalog exemption was granted, and the contract was negotiated on August 7, 1973, at a price of \$2,828,812.

The contracting officer justified the exemption on the basis that (1) the product involved had been developed at company expense, (2) it was recently introduced into the commercial marketplace, and (3) it was closely related to another product in the same family which had already met ASPR requirements for commerciality and catalog exemption.

The product procured, however, was a modified version of a new product which had not yet been sold in the commercial marketplace. In fact, H-P did not start manufacturing any version of the new product until February 1974, 6 months after the negotiation of Navy's contract, when a pilot run of 10 units was made.

In granting an exemption based on the commerciality of another product in the same family, ASPR requires the two products be sufficiently similar to permit differences in prices to be identified and justified without resorting to cost analysis.

From a review of records and data H-P provided, we concluded that the two are not sufficiently similar for price comparison without resorting to cost analysis. Although the basic technology behind the two products appeared similar, the new product was a substantially miniaturized version of the old product and only 15 of the 128 items on the standard parts lists were identical. We therefore believe that the catalog price of the old product provides little assurance as to the reasonableness of the new product's price.

In addition, the lack of comparable quantity commercial sales of the old product raises a further question whether pricing can reasonably be based on catalog price. In his justification for granting the catalog exemption, the contracting officer stated H-P had consistent commercial sales for the similar product of four units a month. However, we believe this sales experience was in sharp contrast to Navy's contract which called for the purchase of 139 units of the new product to be manufactured at a rate substantially greater than 4 a month.

Although this was the only instance of this type noticed, we believe it warrants attention to preclude any possible trend toward relaxing the requirements for catalog exemptions.

Exemption granted for components lacking an identity of their own in the marketplace

A \$2.9 million procurement in our sample included catalog-exempt components representing over 60 percent of the contract price. Eleven of these components, which totaled \$532,760, did not have sufficient commercial sales to qualify for an exemption. For example, 80 units of 1 component with a total sales price of about \$200,000 were exempted even though the H-P commerciality report showed that only 7 units were sold commercially the prior year. In another instance 66 units, amounting to about \$82,500, received an exemption even though the H-P commerciality report showed only 2 units were sold commercially during the prior year. For the latter component H-P used as a basis for the exemption commercial sales of 112 units in 1971, 80 units in 1972, and 60 units in 1973. When questioned about the basis for these reported sales, H-P officials stated that they represented production units, many of which were integrated into another product or system and thus were not separately sold and reported on the commerciality report.

In the absence of an established ascertainable market price for a product or component, there is no assurance as to the reasonableness of the list price established by the contractor. For example, a 12-percent profit was negotiated for a computer test system for which cost or pricing data was provided while the catalog part of the same order was priced at a 7-percent discount off list price. In the case of the component representing an \$82,500 catalog exemption, H-P pricing records indicate a profit of 119 percent when the item was sold at catalog list price. Thus, granting an exemption for the component resulted in the Government paying about twice what it might have paid had cost or pricing data been obtained.

NEED TO CLARIFY DOD POSITION CONCERNING ORIGINAL EQUIPMENT MANUFACTURER DISCOUNTS

H-P keeps separate quantity discount price schedules for certain products sold to customers designated as original equipment manufacturers (OEM). These OEM discounted prices are substantially lower than the catalog list and discounted prices available to non-OEM customers. Although no OEM products appeared in our sample, it was H-P's policy to deny the Government discounts comparable to those provided OEM customers. In the absence of any demonstrated savings in cost associated with sales to OEM customers, we question the propriety and reasonableness of

H-P's policy. We believe DOD should clarify its position on this matter as other contractors may also be denying the Government OEM discounted prices.

H-P has designated certain of its products as available to OEM customers at reduced prices published on OEM progressive quantity discount schedules. The discounts earned by the OEM customer are based on the quantity of specific groups of products purchased in the aggregate over a specified 12-month period. The OEM customer enters into a purchase agreement and estimates the quantities to be procured. At the end of the specified period, any necessary adjustments in price are made to reflect the actual discount earned. A penalty of up to 2 percent is deducted from the discount specified in the OEM discount schedule if the estimated quantity is not procured.

The OEM discounts represent a reduction of up to 15 percent off catalog list price over those discounts available to non-OEM customers. Although OEM discounted prices are based on an aggregate quantity generally procured over a year period, the discounts start at quantities well within those that would occur under individual DOD contracts. For most product groups OEM discounts start at an approximate 15-percent discount for an aggregate quantity of 10 units and progressively increase to 25 to 35 percent discount for aggregate quantities exceeding 100 units. ^{1/} A non-OEM customer procuring 10 units of the same products is given 2 to 5 percent discounts, and the discounts progressively increase to 10 to 20 percent on procurements exceeding 100 units.

To qualify for OEM discounted prices, H-P requires the customer to incorporate an H-P product into its own for resale. H-P stated that OEM discounts are functional in nature and are given in consideration of the role served by the OEM customer in marketing H-P's product and that the discounts are not based on any demonstrated savings in costs or consideration of any particular set of cost factors.

^{1/}The one exception is calculator products for which OEM discounts start at 8 percent with \$50,001 aggregate procurements.

No OEM products appeared in our sample. However, H-P summary sales reports for the first half of fiscal year 1974 indicated DOD procured \$345,000 of these products directly from H-P and DOD contractors procured an additional \$1.6 million. H-P officials stated that the company does not offer the Government OEM discounted prices and that the Government contractors would receive OEM discounts only if they qualified as an OEM.

We did not attempt to ascertain how the prices on DOD fiscal year 1974 procurements would have been affected had OEM discounts been allowed. However, we believe H-P's policy of automatically excluding the Government from OEM discounted prices raises certain basic questions which warrant DOD attention and consideration. These include (1) the propriety of H-P or any other contractor failing to provide the Government discounted prices comparable to those afforded OEM customers procuring in comparable quantities without justification based on demonstrated cost savings and (2) the reasonableness of prices paid by DOD in procurement actions involving OEM products and catalog exemption from certified cost or pricing data.

RECOMMENDATIONS

We recommend that the Secretary of Defense reemphasize to all procurement officials the need to thoroughly analyze contractors' claims for catalog exemption from the requirement for submitting cost or pricing data in support of proposed prices. Special emphasis should be placed on (1) requiring contractors to submit all the necessary data and (2) making an indepth evaluation of all claims for catalog exemption, including audits of sufficient depth and scope to insure that sales data reported is accurate, current, and complete.

We also recommend that the Department consider establishing a minimum period for which data is to be reported and a position on the Government's right to catalog discounts similar to those offered original equipment manufacturer customers.