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*REPORT TO THE SUBCOMMITTEE  
ON PRIORITIES AND ECONOMY  
IN GOVERNMENT  
JOINT ECONOMIC COMMITTEE*

*BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES*



BEST DOCUMENT AVAILABLE

Subcontracting By  
Department Of Defense Prime  
Contractors: Integrity,  
Pricing, And Surveillance

A discussion of subcontracting kickbacks and related transactions, pricing subcontracts valued at less than \$100,000, and the surveillance of contractor purchasing systems.

PSAD-76-23

NOV. 19. 1975

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20541

B-177748

The Honorable William Proxmire  
Chairman, Subcommittee on Priorities  
and Economy in Government  
Joint Economic Committee  
Congress of the United States

Dear Mr. Chairman:

In response to your request, we have summarized our recent work in evaluating Department of Defense prime contractor and subcontractor procurement activities. We also were concerned with whether any prime contractor-subcontractor relationships violated the Anti-Kickback Act (41 U.S.C. 51-54).

At two prime contractor locations, we inquired into the possible existence of kickbacks without any previous indication that such activities were occurring at these locations.

At four other prime contractor locations, we looked into the overall effectiveness of the purchasing and subcontracting systems, including the Government's surveillance of system operations.

ANTI-KICKBACK ACT AND PRIME  
CONTRACTOR-SUBCONTRACTOR RELATIONSHIPS

The Anti-Kickback Act prohibits the payment of any fee or gratuity by a subcontractor to a prime contractor or higher tier subcontractor as an inducement for award of a subcontract. This law applies to negotiated contracts and provides for criminal penalties and recovery by the Government of the amount of the fee. There is, however, no specific contract clause now in use to preclude such payments as those addressed by the act or those which tend to promote favoritism in the award of subcontracts.

In reviewing records at two prime contractors' plants and at selected subcontractor plants, we noted a number of transactions and relationships which we considered questionable because they involved the payment of gratuities or because they otherwise violated good procurement practices. For example:

1. Some subcontractors had given gifts to and had frequently entertained prime contractor employees who were in positions where they could influence purchasing decisions.

B-177748

2. Some prime contractor employees were involved in apparent conflict-of-interest situations.
3. Some purchases had been made through sales agents for no apparent reason, and the prices had been increased to cover the sales agents' fees.
4. Other situations involved questionable transactions and relationships. These examples are described in detail in appendix I.

We discussed with appropriate law enforcement officials those transactions developed during our review where the facts and circumstances indicated possible violations of the Anti-Kickback Act. We understand that the Internal Revenue Service and/or the Department of Justice is currently investigating some of these transactions.

The Department of Justice officials told us in informal discussions that the exchange of low-dollar-value gratuities, such as we found, would not generally be important enough to warrant investigation and prosecution.

Appendix II discusses three kickback cases which were reported to the Department of Justice, independent of our review. Two of these cases are currently under investigation and one--involving kickbacks paid before 1968--resulted in a conviction.

Both prime contractors we reviewed had a policy which discouraged their employees from accepting entertainment, gifts, or other gratuities when such activities were considered unusual or when they might influence, or be thought to influence, employees' judgment in making a purchase or other type business decision. Neither of the two prime contractors, however, had defined what constituted unusual entertainment, and therefore accepting or rejecting offers was left to the employee's subjective judgment. The possible range of acceptable activity is illustrated by the following statements.

--The procurement department manager of one of the two prime contractors said that accepting entertainment from local subcontractors more than two or three times a year was unjustified.

--The security department officials of the same contractor believed that nominal entertainment (e.g. meals and drinks costing from \$5 to \$7.50) received as often as 20 to 30 times a year was not as important as one major entertainment costing from \$100 to \$150.

B-177748

In contrast to the prime contractors' policies discussed above, another major Defense prime contractor's policy is to prohibit the employees' accepting gratuities. For example, the prime contractor's policy statement provides that each employee must:

--Decline any entertainment, gift, gratuity, compensation, or favor offered by suppliers and promptly report such offer to his immediate supervisor.

--Promptly report to his immediate supervisor any gift, gratuity, compensation, or favor received by him from suppliers and then return it to the sender or otherwise dispose of it as directed by his supervisor.

Also each November the prime contractor sends a letter to all active vendors reminding them of the company's policy on gratuities. The letter includes the following statement.

"All \* \* \* personnel are prohibited from accepting any gifts or favors and are required to return anything and everything they receive, whether it be received at work or at home. The value of the gift is not a criterion and all gratuities will be returned to the sender."

Officials of the prime contractor discussed above believe their program is effective because the gift offerings by vendors has almost stopped over the last 10 years, and they cited two examples of buyers who were alleged to have been receiving gratuities and whose employment was terminated.

One of the subcontractors we contacted told us that gifts and gratuities of the type we noted during our review were tax deductible as business expenses. Generally entertainment expenses are deductible under the Internal Revenue Code when incurred in connection with or related to the production of income. Gifts and gratuities are also deductible as business expenses with the limitation that they not exceed \$25 a person. Illegal payments, however, are not allowable business expenses under the Internal Revenue Code. Since it is difficult to prove that small-dollar-value gifts and gratuities such as we noted had influenced the award of subcontracts and therefore violated the Anti-Kickback Act, it appears that such gifts and gratuities could be claimed as business expenses for income tax purposes.

CONCLUSION

We are concerned about gifts and gratuities that have been given to contractor and subcontractor employees who were in positions where they could influence contract awards to lower tier contractors. Because it is difficult to prove that the small-dollar-value gifts or gratuities we noted were given to influence the award of subcontracts, we plan to take no recoupment action under the Anti-Kickback Act. Nevertheless such gifts or gratuities, in our opinion, should be discouraged because they tend to promote favoritism in awarding Government subcontracts, particularly when a pattern of repeated gratuities or entertainment has been established, even though each individual instance may be of small value.

RECOMMENDATION

We recommend that, as a means of fostering public policy against improper or questionable practices, such as those discussed in this report; as a deterrent to such practices; and as a means of increasing the integrity of the Federal procurement process, the Secretary of Defense amend the Armed Services Procurement Regulation to require that in each negotiated Government contract a clause be included specifically prohibiting payments of gratuities by subcontractors to higher tier contractors involved in Government contracting.

The clause is intended to prohibit the payment of gifts and gratuities, regardless of whether a direct relationship between the payment and the specific contract award can be established. It is intended also to prohibit payments by subcontractors to higher tier contractors similar to those we noted during our review, since the clause does not require that it be shown that payments were made as an inducement for or as an acknowledgment of contract awards. Additionally the clause will provide for contract termination--a remedy which is not included in the Anti-Kickback Act but which is in furtherance of public policy against favoritism in awarding Government contracts and subcontracts. Finally the clause will require that violations or suspected violations of the Anti-Kickback Act be brought to the attention of appropriate Government officials.

We suggest that the clause be worded along the following lines, similar to the present contract clause prohibiting giving gratuities to Government employees.

B-177748

PRIME CONTRACTOR-SUBCONTRACTOR GRATUITIES

"(a) No officer, partner, employee, or agent of the contractor or any tier subcontractor holding a contract, agreement, or purchase order to perform all or any part of the work required under a negotiated Government contract shall solicit or accept, directly or indirectly, any gift, gratuity, favor, entertainment, loan, fee, commission, or any other thing of monetary value from any officer, employee, or agent of a subcontractor at any tier which obtained, or is seeking to obtain, work under or related to Government contracts with the contractor or any higher tier subcontractor.

"(b) The Government may, by written notice to the contractor, terminate the right of the contractor to proceed under this contract if it is found, after notice and hearing, that gratuities, as described in paragraph (a) hereof, have been solicited or accepted.

"(c) If this contract is terminated as provided in paragraph (b) hereof, the Government can pursue the same remedies against the contractor as it could pursue if there were a breach of the contract by the contractor.

"(d) If the contractor has information of violations or suspected violations of this clause or of 41 U.S.C. 51, the contractor shall report the facts and circumstances to the appropriate Government contracting officials.

"(e) The contractor shall insert a similar clause establishing the right of the prime contractor or any subcontractor hereunder at any tier to terminate lower tier subcontracts if gratuities as defined in this clause are solicited or accepted."

Since the above clause does not make the payment of gratuities illegal and since it is difficult to prove such payments violate the Anti-Kickback Act or other laws, the Congress may want to consider action to make such payments clearly illegal by amending 41 U.S.C. 51-54 to prohibit such payments as those addressed by the clause or amending the Internal Revenue Code to prohibit deducting such

B-177748

payments as business expenses when paid by a subcontractor to a higher tier Government contractor.

OVERALL EFFECTIVENESS OF  
PRIME CONTRACTOR PROCUREMENT SYSTEM

Our review of the procurement systems of four other prime contractors generally showed their purchasing policies, procedures, and internal controls were based on sound procurement principles. However, several areas needed attention. For example: (1) contractors generally compared past and current prices to measure the reasonableness of current prices for noncompetitive awards valued under \$100,000 although conditions which could affect prices had changed since the past prices were established and (2) other weaknesses in procurement procedures and internal controls at individual contractors' plants, such as failure to consolidate purchase of low-dollar-value items, weakness in bid control procedures, and lack of controls over purchase orders. These areas are discussed in detail in appendix III.

GOVERNMENT SURVEILLANCE

Government surveillance of contractors' purchasing systems is done through annual contractor procurement system reviews, ongoing surveillance by administrative contracting officers, and periodic audits by defense contract auditors.

The Government's annual procurement system reviews are made for the administrative contracting officer to determine whether the contractor's procurement system and practices conform with applicable laws, Government procurement regulations, contract clauses, and sound industrial practices and adequately protect the Government's interests. A favorable determination results in system approval and, in most cases, elimination of the need for Government review and approval of individual subcontractors. Government procurement regulations require cognizant administrative contracting officers to maintain an adequate level of surveillance to insure that the contractor's procurement system continues to warrant an approved status.

Government surveillance regarding kickbacks was limited to determining the acceptability of the contractor's written policies on gifts and gratuities and ascertaining, through discussions with purchasing management, that the policy and the provisions of the Anti-Kickback Act had been made known to the purchasing organization and the vendor community.

B-177748

If Government representatives detect a violation or suspect a violator of the Anti-Kickback Act, they are to refer the matter to higher headquarters for a decision on action to be taken, in accordance with procurement regulations.

In evaluating the overall surveillance of procurement activities at four contractor plants, we found that the contractors' systems had been reviewed and approved on the basis of recent procurement system reviews. Ongoing surveillance was generally restricted to required review and consent to specific types of subcontracts, and annual procurement system reviews were relied on to identify system weaknesses.

The weaknesses we noted had not been identified by either the ongoing surveillance or the periodic procurement system reviews.

RECOMMENDATION

We recommend that the Secretary of Defense direct procurement review teams, during their reviews of contractor procurement systems, to give greater attention to determining whether contractors are conducting adequate price-cost analysis for procurements under \$100,000.

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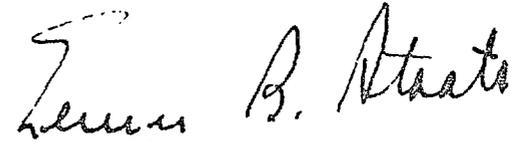
We have discussed the matters presented in this report with local contractor and agency officials but, as your office requested, we have not submitted this report to the Department of Defense for formal written comment.

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

B-177748

more than 60 days after the date of the report. We will be in touch with your office in the near future to arrange for copies of this report to be sent to the Secretary of Defense and the four other Committees to set in motion the requirements of section 106.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Loren B. Attract". The signature is written in dark ink and is positioned above the typed name.

Comptroller General  
of the United States

PRIME CONTRACTOR-SUBCONTRACTOR

RELATIONSHIPS

In reviewing the subcontracting activities of two prime contractors, where special attention was given to possible kickbacks, we found several questionable transactions and relationships.

PRIME CONTRACTOR EMPLOYEES  
PROVIDED GIFTS AND FREQUENT ENTERTAINMENT  
BY SUBCONTRACTORS

Following are examples of situations where subcontractors gave gifts or favors to the prime contractor employees.

Example 1

Two local subcontractors that made over 90 percent of their sales to a Government prime contractor frequently entertained selected employees of the prime contractor. Prime contractor records as of March 29, 1974, showed that these two subcontractors each held over 400 outstanding subcontracts, many more than most other subcontractors. The majority of the subcontracts had been awarded by buyers supervised by procurement employees who had been most frequently entertained. One subcontractor entertained three of the prime contractor's employees a total of 65 times in 1 year. The entertainment generally consisted of meals and drinks costing less than \$25 each time.

The other subcontractor's records showed that the prime contractor's employees had been entertained 189 times during the 2-year period ended September 30, 1974. This entertainment, according to subcontractor records, generally consisted of meals and drinks. However, we found that this subcontractor also had (1) purchased an airline ticket that was used by a prime contractor employee and (2) loaned credit cards and a television set to a buying-group supervisor.

Example 2

A large subcontractor paid over \$200 for gifts and gratuities for a prime contractor's buyer. The gifts and gratuities ranged from golf balls and green fees to an autographed football. During 1972 and 1973 the subcontractor was awarded subcontracts totaling more than \$200,000 by this prime contractor.

The subcontractor told us that its policies and procedures on granting gifts and gratuities conformed to the Internal Revenue Service regulations. One Internal Revenue Service rule (regulation 1.274-3) allows firms to deduct the cost of business gifts to individuals not in excess of \$25 a year. Regulations 1.274-2(c) and 1.274-2(d) allows firms to deduct the cost of entertainment directly related to or associated with the active conduct of a trade or business and directly before or after a bona fide business discussion when the purpose represents an active effort by the taxpayer to obtain income or some other business benefit.

#### Example 3

A subcontractor's sales representative entertained 13 employees of a prime contractor at a total cost of \$431. Those entertained included the former and current directors of material, the manager of central procurement, a buyer, and an expediter. The entertainment included a night at a dinner theater for three employees and their wives and meals and drinks at various clubs and parties for them and for other employees.

#### Example 4

In February 1973 a prime contractor procurement official purchased a used tractor from the subcontractor providing groundskeeping services. He paid \$450 for the tractor and other equipment. The tractor's needed repairs were made at a cost of \$175, which brought his total investment to about \$625.

Local farm implement dealers told us that the market value of a tractor in like condition was between \$1,000 and \$1,200 and one in good condition was about \$1,700. Another official of the prime contractor told us that he did not believe there was a conflict of interest because the procurement official did not get a very good deal on the tractor and there was no indication that favoritism was shown in approving the 1973-74 award to the subcontractor.

#### RELATIONSHIP BETWEEN SUBCONTRACTORS AND SALES AGENTS

There are manufacturers' representatives, sales brokers, and engineering firms throughout the subcontracting structure, and generally they can provide good and valuable services to prime contractors and subcontractors.

APPENDIX I

APPENDIX I

Armed Services Procurement Regulation 15-205.37 dated April 16, 1973, recognizes that selling costs arise in the marketing of the contractor's products and that these costs include sales promotions, negotiation, liaison between Government representatives and contractor's personnel, and other related activities.

The regulation states that the costs are allowable to the extent that they are reasonable and allocable to Government business. Allocability is to be determined in the light of reasonable benefit to the Government from such activities as technical, consulting, demonstration, and other services which are for such purposes as application or adaptation of the contractor's product to Government use.

We identified the following relationships between subcontractors to Department of Defense (DOD) prime contractors and sales agents that did not appear to benefit the prime contractor or DOD.

Example 1

A manufacturer's representative received \$28,500 in commissions from a subcontractor on sales to a DOD prime contractor. The subcontractor increased the price it offered the prime contractor by an amount equal to the commission. Subcontractor officials told us that the commission was not for obtaining business solely with the prime contractor. The commission had been paid under an agreement with the manufacturer's representative who was to develop business for the subcontractor. Because the representative had not developed any business for the subcontractor except that with the prime contractor, the agreement had been terminated.

Example 2

A sales broker who had no plant or equipment had received subcontracts from first-tier subcontractors of a DOD prime contractor. For the one subcontract we were able to fully trace, the sales broker had immediately resubcontracted the entire order to an unqualified producer. The sales broker charged the first-tier subcontractor twice the actual producer's price, and the DOD prime contractor paid almost three times the actual producer's price.

OTHER QUESTIONABLE TRANSACTIONS  
AND RELATIONSHIPS

In reviewing prime contractor and subcontractor activities, we found a number of other questionable transactions and relationships.

Example 1

Two employees of a first-tier subcontractor to a Government prime contractor received about \$6,500 in consultant fees from a surplus-parts dealer. The payments were made after a sale to the surplus dealer that was handled by one of the two employees. The sale involved surplus parts built to the prime contractor's specification. The sale price was \$1,950 for parts having a current market value of about \$190,000.

Neither the prime contractor nor the first-tier subcontractor has acknowledged that the sale resulted in a financial loss. However, the subcontractor dismissed the two employees shortly after we reported this matter to the subcontractor's management.

Example 2

A contract for servicing prime contractor vehicles was awarded without competition to a sales firm that represents a number of the prime contractor's suppliers. An official of the firm also owned and operated a service station.

The sales firm official said that he had contacted one of his friends, a procurement official of the prime contractor, about getting some vehicle maintenance business. This official referred him to a buyer who, in turn, referred him to the manager of transportation material. The sales firm official later received the contract.

The sales firm official later purchased jewelry having a catalog value of \$80 at a 50-percent discount for the manager of transportation, the employee who approved most of the sales firm's vehicle maintenance. The employee reimbursed the sales firm for its cost of the jewelry.

This official is the same one mentioned in example 3 under "Prime Contractor Employees Provided Gifts and Frequent Entertainment by Subcontractors" on page 10 and in example 1 under "Relationship Between Subcontractors and Sales Agents" on page 11.

Example 3

A subcontractor, who had previously produced castings and who held the tooling under an earlier subcontract, had its low bid rejected on a follow-on requirement. Instead an award was made to another source whose price was about \$14,000 higher.

The original subcontractor had tooling in its plant from the previous order and proposed to use this tooling to produce under the new order. The prime contractor's buyer told the original subcontractor that company engineers had said that the tooling in the subcontractor's plant could not be used and that he had therefore rejected the subcontractor's offer.

The subcontractor submitted a memorandum to the prime contractor's management concerning the award to another source. Following investigation of the matter by contractor employees, the award to the second source was terminated and an award was made to the original subcontractor. The subcontractor delivered the castings on schedule, and the prime contractor accepted them.

An official of the original subcontractor told us that he believed the buyer and an engineer had conspired to place the award with the other source because of a possible kick-back. We do not, however, have any facts that indicate that prime contractor employees benefited from the award to the second source.

#### Example 4

A prime contractor's quality control official responsible for accepting material from suppliers established a company to test the hardness of metal fasteners purchased by his employer from these suppliers. This employee-owned company has been operating since 1969 and has earned about \$58,000, most of which was generated from testing done for prime contractor suppliers. No lot of items tested by this company had ever been rejected by the prime contractor.

At the time this employee-owned company was established, the employee consulted management and they found no conflict of interest.

#### Example 5

In 1972 five subcontracts totaling \$2,951 were awarded to a company whose principal stockholders were prime contractor employees. Four of these awards showed that company as the only suggested source; the awards were initiated in the department where two stockholders worked. The buyer who placed the orders told us that he had been unaware that prime contractor employees were stockholders in that company.

APPENDIX I

APPENDIX I

The prime contractor's legal counsel told us that the conflict of interest committee reviewed the above matter and ruled that the three employees had a conflict of interest. As a result the committee directed that these employees dispose of their interests in the supplier company. The disposal action was delayed because of financial problems, and it had not been completed at the close of our review.

KICKBACK CASES

One of the two prime contractors in this portion of our review acknowledged that it had been the victim of a kickback scheme some years earlier. The second contractor told us that it had recently referred a kickback allegation to the Department of Justice. During our review a major subcontractor developed evidence that it too had been the victim of a major kickback scheme. Brief synopses of these three cases follow.

CASE 1

A 1968 investigation by a prime contractor's security group and the Department of Justice developed allegations that 10 of the prime contractor's employees had received entertainment, gifts, transportation, and/or money from 12 subcontractor firms. One employee admitted receiving a total of about \$6,037 in cash from three subcontractors; other employees admitted receiving tickets to sporting events, trips to resort areas, moving expenses, and frequent entertainment.

The employee who admitted receiving \$6,037 and one of the presidents of a subcontractor firm who paid about \$4,125 to him were later convicted of violations of the Anti-Kickback Act. The employee was fined \$5,000; the subcontractor official was placed on probation for 13 months. Five prime contractor employees, including the one convicted, resigned or had their employment terminated. One of these is now employed by a subcontractor to the prime contractor.

In this case the subcontractor made payment to a fictitious firm established in the employee's wife's maiden name. These costs were passed on to the prime contractor as a part of the subcontractor's total price. Reportedly, the scheme was disclosed during bankruptcy proceedings for one of the subcontractors.

CASE 2

During 1973 a second-tier subcontractor to a Government prime contractor had been asked by a first-tier subcontractor to create a fund to be used to pay kickbacks to a prime contractor employee. The fund was to be created by increasing the amount of the second-tier subcontract by \$5,000. The second-tier subcontractor refused to do so and reported the matter to the prime contractor.

## APPENDIX II

## APPENDIX II

Before we started our review, prime contractor officials had referred the case to the Department of Justice for investigation. The prime contractor's internal audit staff also investigated other subcontract awards to the first-tier subcontractor but did not make the results of its investigation available to us.

CASE 3

Late in 1974 an affiliate of a Government prime contractor serving as a first-tier subcontractor discovered that, of about \$151,000 billed by and paid to a second-tier subcontractor, \$125,000 represented duplicate billings. Another second-tier subcontractor was paying a 20-percent commission on sales made to the same affiliate. About one-half, or about \$20,000, of the commission was paid to the affiliate's manager of subcontracts. The affiliate, dismissed nine employees who were directly or indirectly involved.

This matter was discovered as the result of an oral report to the affiliate's management by an informant and was later confirmed by one of the affiliate's cost accountants. This case had been referred to the Department of Justice, and it was actively investigating this case at the close of our review.

AVAILABLE

OVERALL EFFECTIVENESS OF  
PRIME CONTRACTORS' PURCHASING SYSTEMS  
SUBCONTRACTING VOLUME AND EXTENT OF COMPETITION

The amount of DOD procurement dollars awarded to prime contractors, which ultimately are passed on to subcontractors, is important. The ratio of subcontracting volume to total sales for the four DOD prime contractors whose subcontracting activities we examined during this review ranged from about 20 to 55 percent. In 1973 these prime contractors awarded subcontracts totaling approximately \$540 million, including \$210 million in subcontracts of less than \$100,000 each.

At each of the four prime contractors, we examined about 100 procurement transactions totaling almost \$50 million, of which \$7 million worth were under subcontracts of less than \$100,000. Our sampling showed that about 61 percent of the subcontracts had been awarded--83 percent of the dollars--noncompetitively.

EXTENT OF PRICE OR COST ANALYSIS  
AT FOUR CONTRACTORS REVIEWED

Effective price competition assures that the prices obtained are fair and reasonable. However, in a noncompetitive environment other methods must be used to insure fairness and reasonableness of subcontract prices. The methods contractors use most often are price analysis and cost analysis. In certain situations, however, no analysis is deemed necessary because subcontractors are offering goods or services to the Government at the same prices they are offered to the public.

Price analysis involves examining and evaluating a prospective price without evaluating the separate cost elements and proposed profit of the prospective supplier whose price is being evaluated. In contrast cost analysis is much more thorough and involves reviewing and evaluating a contractor's cost or pricing data and the judgmental factors applied in projecting from the data to the estimated cost to form an opinion on the degree to which the contractor's proposed costs represent what performance of the contract should cost, assuming reasonable economy and efficiency.

For subcontracts between \$10,000 and \$100,000, prime contractors generally used price analysis to measure reasonableness. The following table compares noncompetitive awards sampled at the four contractors and the methods used to analyze the prices.

## APPENDIX III

## APPENDIX III

<u>Analysis</u>	<u>Number of orders</u>	<u>Total</u>
Price	62	\$2,579,381
Cost	6	268,246
None	<u>39</u>	<u>1,229,320</u>
Total	<u>107</u>	<u>\$4,076,947</u>

For about half of the transactions, all that the prime contractors did in analyzing prices was compare proposed prices with previous prices. Further, in five instances the price analyses were made after the subcontracts were awarded-- these analyses seem to have been a waste of time since in most cases the prices were already established. In the remaining sample of subcontracts where price analyses were made, the methods used for evaluating the reasonableness of proposed prices included comparison of proposed prices with competitive prices and with in-house technical or engineering estimates and comparisons based on buyers' or requesters' knowledge.

EXAMPLES OF POOR PRICE ANALYSES

A valid indication of the fairness and reasonableness of a proposed price can be obtained by comparing the proposed price with past prices when

- past prices were based on competition or were properly tested for reasonableness;
- other conditions affecting price, such as quality, quantity, and schedule, either remain unchanged or can be reasonably well identified and projected; and
- economic conditions remain stable.

When any of these three conditions is not met, additional price or cost information should be obtained to insure the reasonableness of the proposed price. Many subcontracts valued at less than \$100,000 were awarded although these conditions were not met, and the only work done was a comparison between past and proposed prices.

Past price not based on competition

On August 13, 1973, a prime contractor awarded a noncompetitive purchase order totaling \$60,815.65 for four different proprietary items, as shown below.

<u>Description</u>	<u>Unit price</u>
Coupling, half	\$28.81
Coupling	24.61
Coupling	32.09
Coupling	34.90

The purchase order folio showed that, in evaluating the reasonableness of the quoted prices, the buyer considered the prices previously paid for four previous purchases of coupling halves and three previous purchases of couplings. We determined that the previous buys used in the comparison were also noncompetitive purchases from the same supplier. Detailed cost and pricing data was not requested for the August 1973 purchase. The buyer could not give us any additional factors he had considered in analyzing prices for this purchase. The prices were accepted without negotiation.

Quality, quantity, or schedule requirements changed

For a September 1973 procurement totaling \$83,153, a prime contractor compared the unit prices of production hardware with prices paid in June 1973 for engineering hardware, as shown below.

<u>Proposed procurement</u>		<u>Previous procurement</u>	
<u>Quantity</u>	<u>Unit price</u>	<u>Quantity</u>	<u>Unit price</u>
11	\$680	1	\$405
6	605	2	322
7	605	2	322
19	233	4	50
19	510	3	239
16	510	6	239

In addition, the proposed procurement included \$45,531 for testing and data costs for production hardware compared with \$15,670 for a previous procurement of engineering hardware. The buyer did not evaluate the difference in prices. Increasing the quantity and moving into production from engineering development generally should result in a reduced unit price. The prices in this case, however, were higher than the engineering hardware prices.

Changed economic conditions

On September 11, 1973, a \$38,855 noncompetitive, sole-source purchase order for actuator cylinders was awarded to a supplier which was the only established, qualified source.

The price analysis consisted of comparing the proposed price with previous prices. This comparison showed the proposed unit price of \$1,850.23 to be more than double the latest purchase price of \$922.74. The supplier justified the increase on the basis that negotiations in 1966 were based on large lot runs and that the actual orders received had been in lots of one, five, etc. The supplier concluded that actual cost data showed the part had been a source of profit erosion and that it was necessary to raise the price. There were no negotiations, and the price was accepted.

The purchase history record of this item showed no attempts to analyze the reasonableness of the price increase.

No price-cost analysis before subcontract award

At one contractor location, we identified 19 noncompetitive procurements totaling \$1,001,000, for which required analyses were not made before contract negotiations and award. In 7 cases no analyses were made; in 12 cases analyses were made after negotiations and award. These procurements were identified through random and judgmental selections of procurements.

We compared the negotiation records for the 19 procurements with the sample procurements over \$100,000 whose prices were analyzed before award and found that subcontract prices over \$100,000 had been reduced by more than 10 percent and the 19 awards by only 0.1 percent.

	Results of negotiation	
	With price-cost analysis (over \$100,000)	Without price-cost analysis (\$10,000 to \$100,000)
Proposed price	\$8,649,878	\$1,002,068
Negotiated price	<u>7,220,792</u>	<u>1,000,937</u>
Negotiated reduction	<u>\$ 829,086</u>	<u>\$ 1,131</u>
Percent reduction	10.3	0.1

One explanation for the greater negotiation success with contracts over \$100,000 was the contractor's obtaining certified cost data from subcontractors and determining reasonableness of price through cost analysis.

OTHER WEAKNESSES IN CONTRACTORS'  
PURCHASING SYSTEMS

Certain other matters needed attention for improved purchasing efficiency and control.

Failure to consolidate buys  
of low-dollar-value items

The procedures used at two contractor locations did not encourage consolidating low-dollar-value procurements. The way they were procuring low-dollar-value items resulted in (1) the avoidance of required procedures on competitive purchases and (2) costly administrative expenses which could be disproportionate to the value of the items purchased.

Weaknesses in bid control procedures

At two contractor locations procedures for controlling incoming supplier quotations were weak and could possibly lead to bid manipulations. At each location bids were given directly to the buyers and were not recorded at the time of receipt by an independent unit.

Lack of control over purchase orders

One contractor had a lack of control over purchase orders. Under the contractor's purchasing system, the same numbered document was used as both the purchase requisition and purchase order. The system entailed assigning blocks of purchase requisitions-purchase orders to the functional departments throughout the plant. This procedure resulted in purchase requisitions-orders arriving in the procurement department out of numerical sequence. Complicating the problem, the contractor did not keep a purchase order register.

Lack of management awareness of  
single/sole-source procurements

One contractor's procurement officials were not preparing a monthly single/sole-source report to the director of procurement, contrary to the contractor's regulations. The report was to insure compliance with the contractor's intent to reduce noncompetitive procurements. We found that 62 of 102 purchase orders had been awarded noncompetitively.

Misleading and erroneous data  
in contractor procurement files

At one contractor location misleading procurement data in contractor files created an erroneous impression concerning the sequence in which purchase orders were awarded and

analyzed. Documents in procurement files relative to 7 of the 19 procurements we identified as being placed before price-cost analyses by the responsible department (see p. 20) gave the impression that the analyses had been made before the orders were placed. Two purchase order dates had been changed, four purchase orders were postdated, and one price-cost analysis report date was changed by the buyer.

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We brought the matters discussed in this appendix to the attention of the responsible contractor officials at the close of our review. In most cases the contractors had taken or were considering corrective actions.