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UNITED STATES GENERAL ACCOUNTING OFFICE  
REGIONAL OFFICE  
SUITE 1010, WORLD TRADE CENTER  
350 SOUTH FIGUEROA STREET  
LOS ANGELES, CALIFORNIA 90071

JUN 24 1976

Colonel Harry B. Urey, Jr.  
Commander, Defense Contract Administration  
Services Region  
500 South Ervay Street  
Dallas, Texas 75201

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Dear Colonel Urey:

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We recently completed a survey of the pricing of negotiated contract F34601-73-C-3077 awarded to AiResearch Manufacturing Company of Arizona, Phoenix, Arizona, by the Oklahoma City Air Logistics Center, Tinker Air Force Base, Oklahoma. The multi-year contract for C/KC-135A aircraft cartridge starters was initially awarded for about \$9.9 million, including option quantities. Our objective was to determine the extent of compliance with the requirements of Public Law 87-653, the Truth-in-Negotiations Act, and the implementing provisions of the Armed Services Procurement Regulation (ASPR).

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We did not perform an in-depth examination of the reasonableness of the contract price. Our survey was limited to an evaluation of the procurement process with particular emphasis on the adequacy of field pricing support by contract administration and audit personnel and its use in contract negotiations. We found that applicable defense procurement procedures were effectively implemented with the following exceptions:

- The existing AiResearch bid rate structure for associated manufacturing costs (AMC) may not result in an equitable allocation of costs to Government contracts. We are recommending that the Defense Contract Audit Agency (DCAA) evaluate the estimating process and determine whether the AMC bid rate structure is appropriate.
- The use of two different cost bases for allocating independent research and development (IR&D) expenses appears to be in noncompliance with ASPR 15-205.35(c). The condition also results in the allocation of general and administrative expenses to independent development costs contrary to ASPR 15-205.35(b). We are recommending that the Air Force IR&D negotiator along with the administrative contracting officer require the contractor to comply with the procurement regulation.

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--AiResearch did not update material prices prior to prime contract negotiations although major sub-contract estimates over \$100,000 represented more than 40 percent of the proposed contract price.

The results of our survey are being brought to your attention as the principal administrative contracting agency having responsibilities for coordinating action on matters discussed herein.

Associated manufacturing cost estimates

Associated manufacturing costs include fabrication rework, scrap, obsolescence, inventory adjustments, consignments, warranty, and independent development. AMC costs are allocated over a fabrication cost base. The AiResearch approved AMC bid rates are established by product type (Turbo-Machinery and Control Systems). Within the turbo-machinery product type grouping, however, AiResearch maintains rate data by detailed product codes.

In 1974 and 1975, there were significant differences in the AMC product code rates. For example, the turbo-machinery product codes varied from 11.0 to 52.1 percent of fabrication costs in 1974 and from 13.5 to 52.2 percent in 1975. Historical rates for the turbo-machinery product type grouping for the period were 25.8 and 26.4 percent, respectively. Accordingly, the use of experienced rate data for bidding purposes could result in an inequitable allocation of costs in the initial pricing of Government contracts, depending on the Government/commercial business mix by product codes.

The most recent analysis of the AMC rate structure was performed by DCAA as part of the 1972 bid rate audit. DCAA identified the Government/commercial business mix on 4 of 9 product codes, but provided no basis for the data. The business mix was not identified on the other five. DCAA concluded that the bid rate structure resulted in an equitable allocation of AMC to Government contracts.

In view of the significant rate differences in the various turbo-machinery product codes, we believe that DCAA should perform a thorough analysis to determine whether the existing AMC bid rate structure is equitable in the pricing of Government contracts.

Independent development costs

Independent development (ID) costs are part of the AMC pool and allocated over a fabrication cost base. Independent research and bid and proposal costs are part of the general and administrative (G&A) expense pool and allocated over a cost of sales base including AMC.

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ASPR 15-205.35(c) provides that as a general rule IR&D costs shall be allocated over the same basis as the G&A expense grouping. Where this procedure results in an inequitable allocation of costs, the contracting officer may approve a different base. A formal determination has not been made to justify the allocation base. Since AiResearch allocates ID costs over a different base than the G&A expense grouping, there appears to be a noncompliance with the ASPR provision.

ASPR 15-205.35(b) provides that IR&D costs shall not include an allocation of G&A expenses. The annual advance agreements prohibit the burdening of IR&D costs with G&A expenses, in accordance with the ASPR provision. For contract pricing purposes at AiResearch, however, G&A expenses are allocated to ID costs since they are part of the allocation base. This appears to be contrary with the ASPR provision. The condition does not affect the reasonableness of the advance agreement monetary ceilings since the amounts are not burdened with G&A expenses. However, for contract pricing purposes, ID costs are burdened.

The annual IR&D advance agreement is negotiated on a corporate-wide basis including the Phoenix and Los Angeles divisions. The AiResearch Manufacturing Company of California accumulates ID costs in the AMC pool and allocates G&A expense in the same manner as the Phoenix division. In the 1975 and 1976 audits of proposed IR&D and bid and proposal expense, the cognizant DCAA Los Angeles office noted that the practice appeared to be at variance with ASPR 15-205.35(b).

Cognizant DCAA officials at AiResearch, Phoenix, stated that the use of different bases for allocating IR&D expenses did not result in an inequitable allocation of costs to Government contracts. Any overstatement of contract costs due to the burdening of ID costs with G&A expenses would be offset by an understatement of ID costs in Government cost-type contracts which are excluded from the fabrication cost bases for AMC allocation purposes. The Air Force negotiator stated that ASPR did not prohibit the use of more than one IR&D allocation base. In addition, we were advised that contract audit and administration personnel had consistently recommended acceptance of the AiResearch, Phoenix, IR&D accounting procedure. With respect to the recent disclosure by DCAA, Los Angeles, concerning apparent non-compliance with ASPR 15-205.35(b) by the Los Angeles division, the negotiator stated that since DCAA had not shown that the current procedure was inequitable, there was no basis for change.

In our opinion, ASPR 15-205.35(c) is very explicit with respect to the use of the same IR&D cost allocation base as the G&A expense grouping. A deviation is permitted when the contracting officer determines that the allocation base is inequitable, however, formal determination has not been made. Also, ASPR 15-205.35(b) prohibits the burdening of IR&D with G&A

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expenses. We believe that the Air Force negotiator and the administrative contracting officer should require AiResearch to comply with the procurement regulation to preclude burdening ID costs with G&A expenses in contract price proposals.

Material prices not updated

Bill of material prices supporting AiResearch's initial May 11, 1972, price proposal for contract -3077 were not updated when the January 29, 1973, revised price proposal was submitted to the procurement office. Immediately prior to prime contract negotiations, significantly lower vendor price quotations were obtained by AiResearch on 5 of 8 major subcontract estimates over \$100,000. The current quotations apparently were not disclosed during contract negotiations. AiResearch subsequently awarded the eight subcontracts at about \$480,000 less than the bill of material prices. Although the nondisclosure may not have adversely impacted the pricing of contract -3077 since AiResearch management had voluntarily reduced proposed fabrication costs (including material) by about 20 percent, it may be indicative of a weakness in the estimating system.

Only limited cost analysis was performed by AiResearch on a major noncompetitive subcontract price proposal over \$100,000. A Government assist audit was not requested. Accordingly, less than adequate assurance existed that the subcontract estimate included in bill of material price was reasonable. We believe that DCAA assist audits should be requested on major noncompetitive subcontract price proposals where no cost analysis or limited evaluation are performed by the prime contractor, or where historical negotiated decrement factors are not available from recent procurements with vendors.

We believe that contract administration should consider the material pricing update and subcontract proposal evaluation issues discussed herein during periodic reviews of the AiResearch purchasing system.

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Copies of this letter are being sent to the Commander, Air Force Systems Command, Commander, Defense Contract Administration Services Region, Los Angeles, and Regional Manager, DCAA, Los Angeles, for comment on the respective issues. Any comments you may wish to present on actions taken or planned with respect to matters discussed herein would be welcomed.

Sincerely yours,

J. T. Hall, Jr.  
Regional Manager



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General William C. Evans, USAF  
Commander, Headquarters, Air Force  
Systems Command  
Andrews Air Force Base  
Washington, D. C. 20331

Dear General Evans:

Enclosed for your information is a copy of a letter report to the Commander, Defense Contract Administration Services Region, Dallas, Texas, concerning the results of a recent contract pricing survey at AiResearch Manufacturing Company of Arizona, Phoenix, Arizona.

Your attention is directed to the questionable accounting procedure for independent research and development (IR&D) expenses and its impact on the pricing of Government contracts. This matter is within the authority and responsibility of the Air Force Tri-Service IR&D negotiator to take action. AiResearch uses two different cost bases for allocating IR&D expenses contrary to ASPR 15-205.35(c). Accordingly, for contract pricing purposes, independent development costs are burdened with general and administrative expenses contrary to ASPR 15-205.35(b) and the annual IR&D advance agreement.

We would appreciate if your procurement policy staff would review this matter and advise us of action taken or planned. We would also like to acknowledge the fine cooperation and assistance of Mr. C. M. Brincefield of your staff in providing his views and comments on this matter.

Sincerely yours,

J. T. Hall, Jr.  
Regional Manager

Enclosure



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Brigadier General Michael E. DeArmond, USAF  
Commander, Defense Contract Administration  
Services Region  
11099 South LaCienega Boulevard  
Los Angeles, California 90045

Dear General DeArmond:

Enclosed for your information is a copy of a letter report to the Commander, DCASR, Dallas, concerning the results of a recent contract pricing survey at AiResearch Manufacturing Company of Arizona, Phoenix, Arizona.

Your attention is directed to the questionable accounting procedure for independent research and development (IR&D) expenses and its impact on the pricing of Government contracts at the Phoenix and Los Angeles divisions. AiResearch uses two different cost bases for allocating IR&D expenses contrary to ASPR 15-205.35(c). Accordingly, for contract pricing purposes independent development costs are burdened with general and administrative expenses contrary to ASPR 15-205.35(b) and the Annual IR&D advance agreement. This matter is within the authority and responsibility of the cognizant DCASR Los Angeles and Dallas administrative contracting officers and the Air Force Tri-Service negotiator to take action. We would appreciate your comments on this matter.

Sincerely yours,

J. T. Hall, Jr.  
Regional Manager

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Mr. Alex Soll  
Regional Manager  
Defense Contract Audit Agency  
1340 West Sixth Street, 2nd Floor  
Los Angeles, California 90017

Dear Mr. Soll:

Enclosed for your information is a copy of a letter report to the Commander, Defense Contract Administration Services Region, Dallas, Texas, concerning the results of our pricing survey of contract F34601-73-C-3077 awarded to AiResearch Manufacturing Company of Arizona, Phoenix, Arizona.

We would appreciate your comments on the matters discussed herein, particularly the need for a current evaluation of the existing associated manufacturing cost bid rate structure to determine if costs are equitably allocated to Government contracts.

Sincerely yours,

J. T. Hall, Jr.  
Regional Manager

Enclosure