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UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

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PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

SEP 17 1973

B-167034

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

In April 1973 we reported to the Senate Committee on Armed Services on the effect of section 203 of Public Law 91-441 on payments by DOD for contractors' independent research and development (IR&D) and bid and proposal (B&P) costs (B-167034, Apr. 16, 1973). That report identified issues relating to IR&D and B&P costs which we were planning to examine further.

One such issue was decribed as:

"* * * Concerns expressed by representatives of smaller companies not required to enter into advance agreements about the inequity of applying DOD's formula approach to determine the reasonableness of their IR&D and B&P expenditures. They feel that the formula approach, which is based on recent sales and IR&D and B&P costs incurred, is inadequate for young, fast-growing companies. They contend that their right to appeal for an advance agreement is too burdensome and costly. * * *."

DOD instituted the formula approach by issuing Defense Procurement Circular (DPC) 90 on September 1, 1971. We therefore made a survey to identify problems of small contractors in complying with DPC 90. We concluded that DOD can minimize potential problems by (1) emphasizing to small contractors that compliance with DPC 90 (now incorporated in the Armed Services Procurement Regulation (ASPR), sections 15-205.3 and 15-205.35) is required and may be necessary to avoid disallowance of otherwise legitimate IR&D and B&P costs, (2) making it clear to contractors and contracting officers which DOD representative should negotiate advance agreements with small contractors, and (3) advising the appropriate DOD contracting officers of the criteria to be used in negotiating advance agreements and allowing equitable cost recovery.

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BACKGROUND

DPC 90 revised ASPR sections 15-205.3 and 15-205.35 applicable to B&P and IR&D costs principles. According to DPC 90, contractors need to classify, allocate, and otherwise account for IR&D and B&P costs so they may be readily isolated and identified. Any revisions required in contractors' accounting practices to provide future cost data in the form needed were to be effective for the contractors' first fiscal year starting on or after January 1, 1972.

DPC 90 requires that DOD negotiate advance agreements establishing dollar ceilings for those companies receiving more than $2 million in IR&D and B&P payments from DOD during the preceding fiscal year. For contractors not required to negotiate advance agreements, allowable costs are to be established by formula, either on a companywide basis or by profit centers. The formula limits allowable costs for the current year to 120 percent of the average annual costs for the 2 highest of the preceding 3 years.

DPC 90 states, however, that, at the discretion of the contracting officer, an advance agreement may be negotiated when the contractor can demonstrate that the formula would produce a clearly inequitable cost recovery.

ASPR 15-107, "Advance Understandings on Particular Cost Items," allows either the procuring contracting officer (PCO) or the administrative contracting officer (ACO) to negotiate advance agreements covering IR&D and B&P costs. The PCO generally negotiates advance agreements affecting only one contract or class of contracts from a single buying office; the ACO negotiates all other advance agreements, and the results are binding on all military departments.

We requested the IR&D and B&P project officer for the Defense Contract Administration Services (DCAS) to ask each DCAS region to report the number of small contractors that had initiated requests for advance agreements. Only three contractors, two in San Francisco and one in Baltimore, had initiated such requests; only one had signed a negotiated advance agreement with a DCAS contracting officer.

We discussed DPC 90 implementation with 13 other small contractors in the San Francisco; Boston; New York; and Washington, D.C., areas. Of these, only one had signed an advance agreement, which was negotiated directly with the contracting officer of the contractor's major Government customer and not with the contracting officer at the local DCAS region.

SMALL CONTRACTORS' PROBLEMS WITH DPC 90

Need to emphasize importance of accurate IR&D and B&P records

Because each of the three small contractors that requested an advance agreement from DCAS had not recorded its IR&D and B&P costs in accordance with DPC 90 definitions, its case for DOD funding support was weakened.

For example, contractor A's June 1973 request stated its

> "* * * problem stems from an erroneous interpretation of DPC 90 exempting organizations of [contractor A's] size from its provisions. * * * In connection with a recent proposal audit, this error was brought to our attention, as was the fact that [the contractor] must comply to DPC 90."

This contractor is currently attempting to reconstruct historical evidence to satisfy DPC 90 requirements.

In reply to a Defense Contract Audit Agency (DCAA) request for prior years' actual costs, contractor B advised:

> "* * * that FYE 1/31/73 costs were available. However, these costs for prior years were not segregated and he would therefore not furnish the data."

This contractor said that it would be possible to identify these costs but that developing the information would be difficult and time consuming. DCAA auditors and DCAS price analysts believed that the contractor:

> "* * * should be required to submit all auditable data needed to develop allowable IR&D costs by use of the formula method. Only in this manner can a determination be made that a clearly inequitable cost recovery might result."

Contractor B said also that, on its next attempt to negotiate an advance agreement, it would show that the DPC 90 formula was not necessarily inequitable but was inappropriate. It explained that, since it could not break out prior costs to DCAA's satisfaction, it should be treated as a new company without cost history. This would mean the 120-percent historical cost formula could not be applied and an advance agreement could resolve the supposed inequity.

In the case of contractor C, the ACO decided that analyses were needed because the contractor had not classified or sometimes even recorded IR&D and B&P costs in accordance with DPC 90 definitions for the first 2 of the prior 3 years.

The price analysis report stated:

> "Prior to December 1971, IR&D and B&P labor were not identified in [contractor C's] accounting records. Therefore, recorded costs for this period are not considered as providing a reasonable base in the formula."

According to the report, this contractor's recorded costs produced a formula limitation of $64,310 for fiscal year 1973, whereas the contractor's estimated costs for the same period yielded a ceiling of $126,149. The conclusion of the report was that:

> "* * * the formula produces an inequitable cost recovery * * * and that the granting of some relief of the form of an advance agreement is warranted."

Although other small contractors intend to request DCAS for advance agreements, they have expressed concern about the equity of the Government's determination of IR&D and B&P cost ceilings when historical costs are not recorded by DPC 90 standards. They realized too late that DPC 90 applies to them and are now concerned that the DCAA auditors, somehow, may question legitimate costs and recommend lower overhead rates.

Conclusion

DOD needs to inform small contractors that accurate IR&D and B&P cost records are necessary for either (1) an equitable application of the DPC 90 cost-recovery formula (since the formula is based on historical averages) or (2) an equitable application of DPC 90 provisions for an exception to the formula, i.e., a negotiated advance agreement (since the contractor must demonstrate that the formula results in a clearly inequitable cost recovery ceiling).

Need to clarify who should negotiate advance agreements

DOD guidance is not clear who small contractors should see to negotiate advance agreements. DCAS representatives said that, because DPC 90 does not provide otherwise, the

contractors should follow ASPR 15-107 and negotiate with the ACOs, particularly if the agreement is to be honored throughout DOD. However, some small contractors believe they are permitted to negotiate directly with a major buying agency through a PCO. This raises a question as to the extent such an agreement will be honored.

Only two small contractors have successfully negotiated advance agreements, one with a buying agency and the other with the local DCAS. Other small contractors have indicated that, if possible, they plan to negotiate with their major Government customer rather than with DCAS.

Conclusion

DOD needs to provide guidance to contractors and contracting officers as to when a PCO, rather than an ACO, is the appropriate officer to negotiate advance agreements with small contractors.

Contracting officers need guidance for making equitable determinations

ASPR does not provide criteria to assist the contracting officer in deciding whether (1) a small contractor has adequately demonstrated that the formula results in inequitable cost-recovery amounts or (2) some other approach would result in an equitable basis for an advance agreement.

Contractor C's situation best illustrates this point. The contracting officer agreed that the formula resulted in an inequitable cost ceiling. However, different assumptions, and therefore different estimates, led the two parties to disagree on what would be an equitable ceiling. This contractor finally signed an advance agreement at an amount the contracting officer termed as his final offer. At this point the contractor had lost any leverage for negotiation. Its only alternative would have been to accept the lesser formula amount, already acknowledged to be inequitable.

Conclusion

DOD needs to provide additional guidance to its contracting officers as to what criteria they should use in allowing cost recovery to small contractors. These contractors fear that it will be determined in most cases that they are not properly recording costs within the intent of DPC 90 and that this will cause a part of legitimate costs to be disallowed and, consequently, overhead rates to be reduced.

RECOMMENDATION

We recommend that you clarify the intent of DPC 90 (ASPR 15-205.3 and 15-205.35) so that:

--Small contractors will be aware that the provisions are applicable to them and that the accuracy of their IR&D and B&P cost records affects the recoverable ceiling computed either by formula or by exception to the formula.

--Small contractors and contracting officers will know when an advance agreement may be negotiated with the PCO and the extent that it will be recognized throughout DOD.

--Contracting officers will have guidance for negotiating equitable IR&D and B&P cost-recovery ceilings with small contractors.

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We are sending copies of this report to the Director, Office of Management and Budget; the Director of Defense Research and Engineering; the Assistant Secretary of Defense (Installations and Logistics); the Director, Defense Supply Agency; the Secretaries of the Army, Navy, and Air Force; and the Chairmen of the House and Senate Committees on Government Operations, on Appropriations, and on Armed Services.

We shall appreciate receiving your comments on these matters. If additional information is desired, Mr. Harold H. Rubin, Deputy Director, may be contacted on code 129, extension 4325.

Sincerely yours,

R. W. Gutmann
Director