UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

112806

B-199241

JUNE 26, 1980

The Honorable Thomas J. Downey
House of Representatives

Dear Mr. Downey:

Subject: Investigation of Allegations Regarding ~~Naval Air Systems Command~~ NAVAIR Contracts with Patty Precision Products Company (PSAD-80-57)

At your request, we investigated certain allegations regarding Naval Air Systems Command (NAVAIR) contracts for bomb racks with Patty Precision Products Company, Sapulpa, Oklahoma. We performed our work at NAVAIR Headquarters, the Defense Logistics Agency, the Department of Justice, and the Small Business Administration (SBA) in Washington, D.C.; the SBA Regional Office in Dallas, Texas; the Defense Contract Administration Service Management Area and the Defense Contract Audit Agency (DCAA) Branch in Oklahoma City, and Tulsa, Oklahoma; the Federal Bureau of Investigation and U.S. attorney's offices in Tulsa, Oklahoma; and Patty Precision Products Company, Sapulpa, Oklahoma.

Based on our review, we concluded that:

--A first article inspection clause was not improperly used by NAVAIR in a contract award won by Patty Precision Products Company. (See p. 2.)

--Although out-of-date specifications were used in a solicitation by NAVAIR, generating the need for a subsequent $438,750 change in a contract, other offerors were also aware that the specifications could be changed after the contract was awarded. (See p. 2.)

--No information was withheld from SBA on the issuance of a certificate of competency (COC) for Patty Precision Products Company. We believe SBA's lack of criteria at that time may have hampered its evaluation of the contractor's competency. (See p. 3.)

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--Certain irregularities in Patty Precision Products Company's accounting system resulted in the contractor's receiving $1,455,095 in progress payments prematurely. (See p. 4.)

--Insufficient evidence was available to establish that a buy-in occurred or that the contractor was permitted to "get well" on a subsequent change order on contract N00019-74-C-0448. However, lack of data prevented us from determining whether the price negotiated for the change was fair and reasonable. (See p. 5.)

IMPROPERLY USED INSPECTION CLAUSE

Although a first article inspection clause was allegedly subject to abuse by the contracting officer on a contract awarded Patty, we found this allegation had no validity. One use for the first article inspection clause used by contracting officers is to protect the Government from poor workmanship by contractors who have not previously built the same or similar items for the Government successfully. In this case, Patty had successfully built similar items for the Government, and the NAVAIR contracting officer appropriately waived this clause.

OUT-OF-DATE SPECIFICATIONS

Out-of-date specifications were allegedly used in a NAVAIR solicitation for procuring bomb racks, generating the need for a subsequent $438,750 increase in the contract price. Collusive bidding was implied.

NAVAIR did use out-of-date specifications in a procurement won by Patty, and Patty's contract was increased by $438,750 to incorporate revised specifications. However, there was no evidence of collusive bidding or that Patty was the only potential bidder to know of the likelihood that the specifications would be revised. On the contrary, before the procurement, NAVAIR had solicited the bomb rack manufacturing community for proposals for updating the specifications. According to NAVAIR officials, they used the out-of-date specifications because they did not have Navy drawings available that included the modifications that were being installed and could not wait for new drawings to be

prepared for inclusion in this particular solicitation. This problem has been resolved, and the new drawings and specifications are now being used for competitive solicitations.

COC BASED ON LIMITED REVIEW

You asked us to determine if information was either withheld from or false information provided to SBA in its issuance of a COC for Patty.

SBA is authorized by the Small Business Act, as amended, to issue COCs for small businesses whose bids or proposals have been rejected by a Government contracting officer because of a lack of responsibility based on capacity, credit, tenacity and perseverance, or integrity or because of ineligibility under the Walsh-Healey Act. The contracting officer must notify SBA of such rejections for procurements of $10,000 or more unless the officer certifies the award must be made without delay. A COC effectively overrides the contracting officer's rejection. In this case, the contracting officer properly referred his rejection of Patty's bid to SBA. Our review showed that in evaluating this referral, SBA received and considered information from NAVAIR, Defense Contract Administration Service (DCAS), and DCAA officials. SBA also received letters and visits from Harry R. Patty, Jr., President of Patty Precision Products Company, presenting his side of the case.

An inconsistency exists between the total number of man-hours per week worked listed on SBA's plant survey form prepared by a Dallas regional SBA official and the actual total man-hours per week worked derived from DCAA records. We determined that Patty had provided SBA with both accurate and incorrect projections of hours worked. The SBA official assigned to the case used the incorrect projections, ignoring the correct data Patty provided, and also made an error in computing total hours worked. However, we believe these errors were not sufficient to have influenced SBA's decision to issue a COC for Patty because they related only to the size of Patty's operations.

We believe SBA may have been hampered in its review of the issues in this case because SBA file documents revealed that guidance for tenacity, perseverance, and integrity cases were not clear. A review of COC interim procedure documents showed no criteria existed for integrity cases

and for tenacity and perseverance cases only six suggested steps for gathering information were thought to be useful. According to SBA officials, their criteria for issuing COCs for tenacity, perseverance, and integrity were being revised at the time they received this referral from NAVAIR in December 1978. Although Public Law 95-89, on August 4, 1977, broadened SBA's authority to issue COCs to include referrals for tenacity, perseverance, and integrity, firm criteria for dealing with such referrals were not issued until March 3, 1980.

PREMATURE PROGRESS PAYMENTS

A disparity of $1,455,095 allegedly existed between the contractor's general ledger and his job cost ledgers. We confirmed this allegation and the fact that it permitted Patty to claim and receive progress payments prematurely.

Patty requested and received $1,490,977 prematurely during the period September 1, 1975, through August 31, 1978. The Government calculates it cost $175,578, reflecting the cost of money at the average annual Treasury rate to replace the money it paid Patty prematurely. In effect, Patty was receiving interest-free financing of its operations for that period of time.

The cause for premature payment was twofold. First, the contractor overstated its requests for progress payments because of various accounting irregularities or circumstances that resulted in its job cost ledgers being inflated and not agreeing with its general ledger. Secondly, DCAA, which has the responsibility to audit progress payment requests, does not routinely reconcile job cost ledgers to general ledgers but accepts the job cost ledgers as the basis for making progress payments once it finds the contractor's accounting system and controls to be sufficient and reliable for segregating and accumulating contract costs. In a March 9, 1978, audit report, DCAA found Patty had amounts in its job cost ledgers greater than that reported in its general ledger. DCAA offered a qualified opinion on whether progress payments were commensurate with work performed and recommended Patty be required to provide an explanation and data to reconcile its job cost ledgers and general ledger or certified financial statement to be used in processing future progress payments. In a November 30, 1978, audit report, DCAA suggested the administrative contracting officer consider the feasibility of recovering from Patty the estimated excess financing costs resulting from premature progress payments.

This matter was referred to the Federal Bureau of Investigation to investigate whether any criminal violations had occurred. The Federal Bureau of Investigation turned over its findings to the U.S. attorney's office in Tulsa, Oklahoma, which decided not to prosecute. One reason given for not prosecuting was that administrative remedies were available to the Government to recover the cost of providing excess progress payments. No actual funds were lost as the work paid for was eventually performed. However, it took DCAS more than 1-1/2 years after it first detected accounting irregularities to demand payment of interest on premature progress payments. Further, both the Defense Acquisition Regulations and the Defense Logistics Agency Manual clearly specify that progress payments should be suspended if a contractor's accounting system is found to be inadequate to identify costs in support of progress payment requests. However, DCAS did not act to suspend further payments even though an August 22, 1978, DCAA audit report found Patty's accounting system inadequate to properly identify, accumulate, and report costs. We believe DCAS should have suspended progress payments to Patty until the discrepancy between the contractor's job cost ledgers and general ledger was resolved. This matter is no longer an issue because accounting adjustments have been made and Patty's job cost ledgers now agree with its general ledger.

On November 27, 1979, the administrative contracting officer demanded payment of $175,578 from Patty. Patty has admitted receiving progress payments early but has appealed the amount demanded for interest to the Armed Services Board of Contract Appeals, claiming that only $99,882 is owed to the Government. The case is still pending.

RECOVERY OF BUY-IN

You raised a question regarding the disparity of unit prices between the initial quantity of bomb racks competitively awarded under contract N00019-74-C-0448 and those for an additional noncompetitive, foreign military sale requirement. According to the Navy, the original competitive price may have been a buy-in at a price significantly below its intrinsic value.

Buying in refers to the practice of attempting to obtain a contract award by knowingly offering a price or cost estimate less than the anticipated cost, expecting to either (1) increase the contract price during the period of performance through change orders or other means or (2) receive future follow-on contracts at prices high enough to recover any

losses on the original buy-in contract. It is not illegal for contractors to bid below their anticipated costs. However, Defense Acquisition Regulations require that, when there is reason to believe that buying in has occurred, contracting officers shall assure that amounts excluded in the development of the original contract price are not recovered in the pricing of change orders or follow-on procurements subject to cost analysis.

We found insufficient evidence to establish that (1) a buy-in as defined by Defense Acquisition Regulations occurred or (2) the contractor was permitted to get well on a subsequent change order to contract N00019-74-C-0448. However, modification P-0008 to the contract was for a foreign military sale and was negotiated at a unit price of $6,293, or nearly three times the unit price of the basic contract for the same bomb rack. Further, only 1 month before, Patty submitted a competitive proposal for identical bomb racks at a unit price of $3,650 and won that award. Also, less than 2 years after it submitted its proposal for modification P-0008, Patty submitted a competitive bid for identical bomb racks at a unit price of $3,650 and won that award. A schedule of these bids and awards follows:

Contract no.	Date of bid	Date of award	Unit price	Number of units
N00019-74-C-0448 (competitive award)	3/13/74	4/18/74	$2,400	1046 BRU-10A/A
N00019-75-C-0096 (competitive award)	9/25/74	11/12/74	3,650	271 BRU-10A/A
C-0448 Mod 8 (sole source, foreign military sale)	10/25/74	3/27/75	6,293	152 BRU-10A/A
N00019-76-C-0587 (competitive award)	5/21/76	8/ 4/76	3,650	494 BRU-10A/A

We believe the above facts (excluding C-0587), which were available to the NAVAIR contracting officer at the time of the contractor's proposal for Mod P-0008 to N00019-74-C-0448, should have alerted him to the possibility of the recovery of a buy-in and that he should have assured that such recovery did not occur as a result of the pricing of this modification.

However, lack of data prevented us from evaluating the contracting officer's price negotiation for the change or determining whether the price was fair and reasonable based on the contractor's cost or pricing data.

NAVAIR officials said they had lost all the documents used to negotiate the contract price on this contract modification except one relevant document, the business clearance document or price negotiation memorandum NAVAIR had prepared for the negotiation. It contained only the summary of the recommendations made by DCAA and DCAS together with the NAVAIR negotiator's position. Further, we could find no evidence of any detailed analysis in DCAS files supporting its technical evaluator's conclusion that the contractor's proposed direct labor hours were fair and reasonable. When questioned, the evaluator said his workpapers were either lost or destroyed, but he didn't know how or when it happened. Also, the DCAS price analyst said that he had purged his files recently and no longer had any details of his analysis supporting his recommendation of a contract price to NAVAIR.

DCAS regulations generally permit proposal evaluation records to be destroyed 3 years after they are prepared. However, contractors are required to keep their contract records for 3 years after final payment on the contract. These regulations are not in agreement and could work against the Government.

RECOMMENDATIONS

Accordingly, we recommend that the Secretary of Defense change the retention period for Government contract records to agree with the Defense Acquisition Regulations pertaining to contractor records.

As requested by your office, we did not obtain agency or contractor comments. Unless you publicly announce its contents earlier, no further distribution of this report will be made until 14 days after the date of the report. At that time, we will distribute the report to the Secretaries of Defense and the Navy; Commander, Naval Air Systems Command; DCAS and DCAA officials; the Administrator, SBA; Patty

Precision Products Company; and other interested parties. We will be available to respond to any comments or questions that you may have.

Sincerely yours,

for W. H. Sheley, Jr.
Acting Director