DEPARTMENT OF DEFENSE

AUDIT REPORT

NAVAL MILITARY PERSONNEL COMMAND PLANNED
PROCUREMENT OF AUTOMATED DATA PROCESSING EQUIPMENT

NO. 90-019

DECEMBER 15, 1989

Office of the
Inspector General

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

REPORT NO. 90-019 December 15, 1989

MEMORANDUM FOR GENERAL COUNSEL
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
DEPUTY ASSISTANT SECRETARY OF DEFENSE (PROCUREMENT)

SUBJECT: Audit Report on the Naval Military Personnel Command (NMPC) Planned Procurement of Automated Data Processing Equipment (Project No. 9ID-5005.1)

Introduction

This is our final report on the Naval Military Personnel Command (NMPC) Planned Procurement of Automated Data Processing Equipment. We made the audit, at the request of the Secretary of Defense, from January 5, 1989, through May 25, 1989. The audit stemmed from allegations that the NMPC was using a firm, qualified under the Small Business Administration (SBA) Section 8(a) Program of the Small Business Act of 1958, to purchase computer equipment for NMPC in a manner that inhibited competition and favored the International Business Machines Corporation (IBM). Under the Section 8(a) Program (the Program), the SBA is authorized to enter into contracts with Government agencies and then subcontract the contractual requirements to economically and socially disadvantaged businesses. The Program is intended to foster business ownership by disadvantaged individuals and to help eligible firms become viable and competitive in the open market.

The overall objective of our audit was to determine whether the NMPC inhibited full and open competition in its attempt to buy a secure processor (a computer processor used to manage classified personnel information). Other objectives were to determine whether there was bias toward any single vendor as alleged in a letter to the Secretary of Defense and to determine whether the NMPC was using a Section 8(a) vendor to circumvent competition.

The allegation against the NMPC was one of many made by a group of six computer vendors. Significant media and congressional interest in the allegations exists, and several reviews of the allegations have been initiated. On November 8, 1989, the House Subcommittee on Legislation and National Security,

Committee on Government Operations, began hearings on the Navy's acquisition of computer equipment. Also, the General Accounting Office initiated three projects addressing the vendors' allegations. Furthermore, the Navy initiated its own investigation to determine the adequacy of full and open competition during computer equipment acquisitions. Since our audit addressed only one of the procurements cited in the vendors' allegations, we did not make conclusions on the overall allegations that the Navy systematically favored IBM.

Scope of Audit

Our audit focused on the NMPC planned procurement of a secure processor estimated to cost about $950,000. This procurement was one of seven Navy procurements specifically mentioned in the vendors' allegations. We reviewed all available documentation developed from March 1986 to May 1989 that related to the planned acquisition. We examined documents, correspondence, and minutes of meetings prepared by the Navy, its two Section 8(a) firms (PSI International, Incorporated [PSI] and National Capital Systems, Incorporated [NCSI]), the SBA, IBM, and the ViON Corporation (ViON). We evaluated the functional requirements for the secure processor in the Systems Decision Paper and a performance study of projected computer requirements. The performance study was developed by a contractor and used by the NMPC to justify the acquisition of the processor. Records on the computer hardware inventory in the Navy's Automatic Data Processing Equipment Reporting System for NMPC were reviewed. We also reviewed information from DoD's DD 350 data base to identify NMPC's hardware procurements. The DD 350 data base contains information on DoD contracts costing more than $25,000. We reviewed Navy and SBA contract files on PSI and Navy contract files on the NCSI. We compared the procurement process used by the NMPC to criteria specified by the Federal Acquisition Regulation (FAR) and the Federal Information Resources Management Regulation (FIRMR) (Title 41 of the Code of Federal Regulations). In addition, we discussed certain procurement matters relating to the audit with the DoD Standards of Conduct Officer of the Office of the General Counsel, DoD.

Documentation was either lacking or inadequate on what had transpired in procuring the processor through PSI. The tasking for the procurement was oral, and the meetings between the NMPC and PSI were not completely documented. Accordingly, we relied on the available records and the interviews and statements from the key personnel who were involved in the procurement. We met with the six vendors to obtain details of their allegations. We also met with personnel from NMPC; PSI; the Naval Regional

Contracting Center (NRCC), Washington; IBM; ViON; and NCSI. In many instances, we received conflicting statements on what had transpired and on what NMPC's and PSI's intended actions were involving the procurement. Enclosure 5 lists the activities we visited or contacted during our audit.

The audit identified internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Controls were either not established or ineffective to prevent NMPC's project manager for the acquisition from acting outside the scope of his authority. This deficiency resulted in noncompliance with Federal procurement regulations. Recommendation 3. in this report, if implemented, will correct the weaknesses. We have determined that monetary benefits will not be realized by implementing Recommendations 1., 2., 3., and 4. A copy of this report will be provided to the senior official responsible for internal controls within the Navy. This program results audit was made in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD, and accordingly included such tests of internal controls as were considered necessary.

Background

The NMPC is responsible for the administration and assignment of military personnel to meet Navy staffing requirements. Additionally, NMPC assists in career development for military personnel and implements Service-wide programs for improved human relations. NMPC performs its mission with a staff of 1,186 military and civilian employees. In addition to NMPC's Headquarters, Arlington, Virginia, NMPC has detachments, field activities, and shore activities throughout the country. In fiscal year 1989, the NMPC's operating budget was $112,153,000.

NMPC's Technology Support Division (the Division) is responsible for administering computer networks and telecommunications technologies in support of NMPC's mission. The Division manages information on personnel and training. Additionally, it is responsible for operating NMPC's data center and for developing requirements for the acquisition of computer hardware to support the NMPC's automated systems. The Division was responsible for managing the procurement of the secure processor.

In July 1986, the NRCC awarded PSI a cost-plus-fixed-fee contract (Contract N00600-86-C-2922), valued at almost $13 million, to manage and operate the data center at NMPC. PSI

was incorporated in the Commonwealth of Massachusetts on February 3, 1977. The SBA accepted PSI into the Section 8(a) Program for small and disadvantaged businesses in December 1977. PSI maintains offices in Boston, Massachusetts; Falls Church, Virginia; and Fairfax, Virginia. PSI performs the contract work using Government-furnished facilities and equipment.

NCSI is another NMPC contractor that is also qualified under the Section 8(a) Program. NCSI conducted a computer performance study for NMPC, which recommended the purchase of an upgraded secure processor. The NCSI's contract, number N00600-87-C-1503, is valued at $2,423,616.

Prior Audit Coverage

On May 9, 1989, we issued Report No. 89-073, "Quick-Reaction Report on the Review of Naval Military Personnel Command (NMPC) Planned Procurement of Automated Data Processing Equipment." That report was part of our audit at NMPC and addressed procurement actions made after NMPC ended the use of a Section 8(a) contractor in the procurement. The report showed that specifications for NMPC's procurement were too restrictive and that anticipated upgrades were not included as part of the source selection process. The report also showed that an announcement of the procurement made by the NRCC in the Commerce Business Daily was misleading and could be misinterpreted as a sole-source procurement of IBM equipment. It is our opinion that these conditions resulted in a planned procurement that favored IBM.

We recommended that NMPC suspend the planned procurement until it developed less restrictive specifications. We also recommended that NMPC obtain an industry review of the acquisition as recommended by the FIRMR Section 201-32.107, include expected upgrades to the secure processor as a contract option, and consider the cost of those upgrades in the source selection process. We recommended that the NRCC withdraw its announcement of the procurement in the Commerce Business Daily. The Navy generally agreed with our recommendations.

On June 21, 1989, the General Accounting Office (GAO) issued "Navy Improperly Restricted Competition for Its Civilian Pay System," Report No. GAO/IMTEC/89-61 (Case number OSD 8041). That report was in response to the vendors' allegations that the Navy was showing favoritism toward IBM. The report focused on the procurement for the Navy Standard Civilian Pay System (NAVCIPS). The procurement was one of seven procurements stated in the vendors' letter. GAO found that the Navy deviated from accepted practices for systems development in making several key technical

decisions. Specifically, without conducting appropriate studies and developing adequate support, the Navy selected a data base management system, hardware, and 10 sites where the system would operate. The GAO concluded that, taken together, these decisions concerning the Navy's hardware procurements improperly restricted competition to specific IBM hardware and related equipment.

The GAO recommended that the Assistant Secretary of the Navy (Financial Management) cease further hardware and software orders under the contract; conduct a cost-benefits analysis for the full range of site alternatives; recompete the NAVCIPS' requirements using functional specifications; and determine whether to continue the contract, to limit orders to the minimum required, or to terminate the contract for the convenience of the Government and award a new contract for the requirements.

The GAO is conducting two additional reviews of related issues within DoD:

- "Government-Wide Contracting for Information Technology," announced February 22, 1989 (job code 510377); and

- "ADP Related Procurement Practices," announced April 12, 1989 (job code 510383).

Discussion

NMPC's efforts, through PSI, to negotiate prices exclusively with IBM for the acquisition of a secure processor circumvented full and open competition. Because PSI does not, in the usual course of business, manufacture nor stock and sell computer processors to the public, we believe that a broker relationship, contrary to existing laws and regulations, was created between NMPC and PSI in the attempted procurement. Additionally, the NMPC's Contracting Officer's Technical Representative (COTR), who was the project manager for the procurement, took actions to solicit bids, conduct negotiations, and perform price analyses that were outside the scope of his authority. PSI acted outside the scope of its contract in attempting to purchase equipment for NMPC while NMPC was engaged in an unsuccessful attempt to modify the contract to include that service. Further, PSI did not notify the contracting officer in writing, as required under the terms of its existent contract, that work outside the scope of the contract had been requested by NMPC, prior to taking action on the request. We believe that these conditions were caused by the project manager's unfamiliarity with Federal procurement regulations, and that the resultant negotiations gave the appearance of favoritism toward IBM. Using PSI, a Section 8(a)

contractor, as a broker in the procurement is in conflict with the Walsh-Healey Act and the SBA regulations on eligibility for participation in the Section 8(a) Program. The procurement attempt through PSI resulted in closed competition and noncompliance with procurement regulations.

During the audit, we became aware of potential mischarging of costs on NMPC's contract with PSI. Details on the potential mischarging are provided in the report in the paragraph titled, "Contract Costs." Additionally, we noted other SBA regulatory issues that we brought to the attention of the SBA's Office of the Inspector General.

Selection of Vendor. NMPC's attempt to buy the secure processor through PSI occurred during the first half of 1988. In the attempted purchase, both NMPC and PSI favored IBM equipment, which is evidenced by the system justification, NMPC's reliance on IBM in developing its acquisition strategy, initial exclusive negotiations with IBM, and NMPC's evaluation of vendors' proposals.

System Justification. NMPC listed its requirements and system justification for the secure processor as IBM equipment. Both NMPC's performance study and life-cycle management documentation stated requirements in terms of an IBM 3090 Model 120E.

The performance study was conducted in April 1988 by NCSI, a Section 8(a) contractor under contract to NMPC. The purpose of the study was to estimate the computer resources required to perform classified processing for Navy personnel applications and to recommend computer systems capable of supporting the requirement. The study identified current and future Automatic Data Processing (ADP) resource requirements in terms of a specific make and model of equipment, concluding that NMPC should buy ". . . equivalent to or greater than an IBM 3090 Model 120E. . . ."

In accordance with Navy life-cycle management rules for procurement of ADP equipment, the NMPC project manager prepared a Mission Element Needs Statement and an Abbreviated Systems Decision Paper (the Decision Paper), which provided justification for the proposed buy. Citing the performance study, the Mission Element Needs Statement justified the need for the processor based on projected work loads and the approaching obsolescence of the hardware in use. The hardware was already on the General Services Administration "Outdated Automated Data Processing Equipment" list (FIRMR Bulletin 5 series). The Decision Paper proposed an IBM 3090 Model 120E (brand name or equivalent):

> The NMPC secure processing resource constraints can be eliminated, from both a capability and capacity perspective, through the development and deployment of TFMMS [Total Force Manpower Management System], by procurement of an IBM 3090-120E, a half string of 3X density DASD [triple density direct access storage devices (disk drives)] and a half string of 2X [double] density DASD.

The Decision Paper, approved on July 12, 1988, included a list that stated all requirements in IBM product numbers (including the product numbers for blue console covers, the color traditionally used for IBM equipment).

Acquisition Strategy. IBM was heavily involved in the development of NMPC's acquisition strategy. An IBM marketing representative performed research on procurement alternatives, specifically, on how the processor could be purchased through a Section 8(a) contractor. Furthermore, an IBM procurement consultant gave a presentation to the NMPC on how NMPC could procure the processor. In February 1988, the NMPC project manager contacted its IBM marketing representative and requested that IBM research how NMPC could use a Section 8(a) contractor for the intended buy. NMPC told us that it believed that a contractor could conduct the procurement faster than NMPC's contracting support activity, the NRCC. The IBM representative prepared a checklist, which included SBA and Navy contracting personnel names and telephone numbers, on how to obtain the equipment through a Section 8(a) contractor. After receiving the checklist, NMPC decided to use PSI to acquire the processor and attempted to modify PSI's contract to change its "scope of work," thereby authorizing PSI to make the purchase.

Procurement Presentation. In June 1988, at the suggestion of an IBM marketing representative, NMPC personnel met with an IBM procurement consultant for a presentation on NMPC's intended procurement. The IBM consultant told us that the purpose of the presentation was to help NMPC to better understand and interpret ADP acquisition regulations. During the presentation, the use of a Section 8(a) contractor to acquire ADP equipment was specifically discussed. The IBM consultant told us that NMPC wanted details on the use of PSI to acquire the equipment. Other topics covered during the presentation included preparation of the Request for Proposals, vendor support

criteria, evaluation factors for award, and development of specifications. Portions of the Request for Proposals to purchase IBM-compatible equipment were provided by the consultant and discussed during the presentation.

The IBM consultant stated that she had provided similar presentations to OSD and the Services since March 1987. At our request, the consultant provided a list of DoD activities that had participated in her presentations. Below is a summary of the list which shows that the Navy received the most presentations.

Activity	Number of Presentations	Percentage
OSD Activities	8	11
Army	15	21
Navy/Marine Corp	30	42
Air Force	15	21
Army and Air Force Exchange Service	1	2
Undetermined	2	3
Totals	71	100

The IBM consultant told us that she believed she was providing a valuable and needed service to the activities. She stated that some of the DoD activities did not understand the Government acquisition process and were geographically separated from the contracting officers that assisted activities with computer buys. Her presentations were usually arranged by an IBM marketing representative whenever the representative became aware of a Government need for IBM or compatible equipment upgrades. She stated that presentations were free of charge and made before a DoD activity had developed its hardware specifications.

We recognize that DoD activities may need assistance in buying ADP equipment or services because they may lack the experience or skills necessary to properly conduct an acquisition. However, we believe that DoD activities should not obtain assistance on acquisition policy, procedures, or related issues from sources who may later offer to sell ADP equipment or services to the activity. Such assistance, particularly at the formative stages of an acquisition, has the potential for biasing the specifications toward the vendor and, at a minimum, gives the appearance of favoritism. FAR 3.101 requires that Government business will be conducted in a manner above reproach, with complete impartiality, and with preferential treatment for none. Additionally, DoD Directive 5500.7, "Standards of Conduct,"

requires that DoD personnel avoid any action that might result in or reasonably be expected to create the appearance of giving preferential treatment to any person or entity or of losing independence or impartiality. Furthermore, procurement assistance can be obtained through a variety of Government sources, such as the General Services Administration and contracting officers. Training courses in procurement of ADP are available through the DoD and other Government sources.

Negotiations. While NMPC was attempting to modify the contract, PSI was negotiating exclusively with IBM for the purchase of the processor. In our opinion, this negotiation indicated a preference for the IBM equipment. Not until PSI and NMPC decided that IBM's price for the processor was too high, did PSI look for an alternative source.

Contract Modifications. During early 1988, NMPC tried to modify the PSI contract to change the scope of work. Initially, this modification was to correct problems with labor rates, the number of contractor employees on site, and PSI's relationship with subcontractors. NMPC used this opportunity to add a provision to the contract, which it believed would give NMPC the authority to purchase supplies (i.e., the secure processor) through PSI. The provision stated, "The contractor will be responsible to . . . Provide engineering changes and/or information technology upgrades." The modification had not been approved by the NRCC contracting officer who told us that she was unaware that the provision was intended to give NMPC the authority to purchase supplies through PSI. The NMPC told us, however, that this approach to hardware procurement had been discussed with the NRCC's contracting officer, who believed this approach was procedurally correct, but was not willing to approve the modification.

Tasking of PSI. The NMPC project manager handling the procurement stated that during the contract modification attempt, NMPC orally tasked PSI to research hardware systems for the secure processor requirement. In discussions with us, NMPC officials made conflicting statements regarding the PSI tasking. According to the Director of the Total Forces Information Systems Management Department, NMPC, PSI was tasked to look at alternative vendor systems or to conduct market research. Later, the Director told us that PSI was not tasked to do market research, but rather to conduct research on IBM equipment. The Director of the Technology Support Division, NMPC, denied that NMPC had tasked PSI to look into possible hardware systems for its secure processor requirement and said he was unaware that PSI had conducted price negotiations with IBM.

We found that PSI had conducted price negotiations with IBM, had solicited proposals from two other vendors, and had performed a price analysis of the resulting proposals. Such actions were clearly outside the scope of PSI's contract.

The terms of the PSI contract required PSI to notify the NRCC contracting officer in writing when there was a request for work outside the scope of the contract and to take no action until the NRCC contracting officer issued a contractual change. PSI provided no such notification.

Price Negotiations. The PSI technical project manager in charge of the NMPC task told us that he negotiated "very hard" with IBM to obtain a purchase price within NMPC's funding limitation for the secure processor. His negotiations were based on the premise that the contract modification would allow PSI to buy the processor for NMPC. When IBM would not reduce its price, PSI suggested that NMPC look at hardware sold by other vendors.

Solicitation of Proposals. In July 1988, the NMPC project manager invited ViON Corporation and Amdahl Corporation to present and discuss their IBM-compatible hardware. Shortly after the meeting with ViON, the project manager instructed ViON to submit a proposal to PSI. In August 1988, ViON provided a proposal to the PSI technical project manager. At that time, PSI told ViON it would also meet with IBM, and after both meetings, PSI would make a recommendation for award to the NMPC. PSI provided IBM a detailed list of required IBM equipment and requested that IBM submit its "best-and-final" price. IBM responded with its proposal. Amdahl met with NMPC, however, Amdahl declined to submit a proposal on the acquisition because its available products exceeded NMPC's requirements.

Proposal Evaluation. During August 1988, the PSI project manager developed a cost analysis for the life cycle of the IBM and ViON processors. The analysis showed that ViON had the most cost-effective secure processor. The ViON proposal was priced substantially below the IBM proposal and was well within NMPC's available funds. The PSI project manager stated that he recommended the ViON proposal over the IBM proposal because of the lower price and because it met technical requirements. He stated that he also discussed the proposal with NMPC personnel on several occasions following his initial recommendation. NMPC officials, however, denied ever receiving his recommendation.

Regardless of whether a recommendation was received by NMPC, we do know that the NMPC project manager favored IBM equipment.

He believed that purchasing IBM equipment would result in fewer technical problems and better resolution of problems that might occur. During one interview, he told us, "IBM is one of the few corporations that I can buy a system from, front to back, that will work and do the job . . . I'm not buying problems, I'm buying solutions." Additionally, when ViON called the NMPC project manager to discuss the status of the procurement, ViON was told that NMPC preferred an IBM processor and that although ViON had a "good" processor, NMPC was leaning toward IBM. The project manager also told ViON that ViON's price was much less than IBM's, but that IBM had better equipment.

NMPC's only documented analysis of the proposals was: "IBM - low risk, high system support; NAS [National Advanced Systems, the processor marketed by ViON] - lower cost, low system support; Amdahl - smallest machine, 3 sizes too big." In many source selections, the lowest total cost to the Government is the deciding factor. However, the Government may select a source whose proposal offers the greatest value in terms of performance and other factors stated in the solicitation document. Because neither NMPC nor PSI prepared a solicitation document, it was not clear to us what evaluation factors either NMPC or PSI intended to use for the award.

NMPC Contracting Authority. In the attempt to buy the secure processor, the COTR, the project manager for the procurement, performed certain procurement actions that neither he nor PSI was authorized to perform. These actions included soliciting bids, conducting negotiations, and performing price analyses. FAR 15.604(c) states that such contractual actions can be performed only by the contracting officer. The COTR was responsible only for monitoring progress and technical surveillance of the services performed by PSI.

Termination of PSI's Procurement Effort. During October 1988, NMPC terminated its attempt to purchase the secure processor through PSI. Two events prompted this decision:

- ViON Corporation's complaint to the Navy on the procurement procedures being used, and

- NRCC's resistance to approve NMPC's procurement strategy to buy the secure processor through PSI.

After ViON learned of the Navy's preference for IBM equipment, ViON complained to the NMPC Chief of Staff and the NRCC contracting officer. NMPC's Chief of Staff contacted the NMPC personnel involved in the procurement. The NRCC contracting

officer informed NMPC and PSI that PSI was not authorized to conduct a procurement, because procurement was outside the scope of its contract and that the Navy requires that contracts for computer equipment purchases costing less than $10 million are to be awarded only by the NRCC. The NRCC contracting officer told us that she had not been aware of NMPC's efforts to buy the equipment through PSI until ViON contacted her.

The NRCC's contracting officer believed that NMPC and PSI were unfamiliar with contracting regulations and that this unfamiliarity affected their actions. On October 31, 1988, NMPC informed ViON that the NMPC was going to conduct a full and open competitive procurement for the secure processor through the NRCC.

Buying Computer Equipment for the Government. The NMPC's effort to use PSI as a broker to buy the secure processor for the Government was in conflict with the Walsh-Healey Act, U.S.C., title 41, section 35(a). The Act, which is applicable to Section 8(a) contractors, requires that a contract be awarded only to the manufacturer or regular dealer of the equipment. In addition, the SBA regulations (Title 13 Code of Federal Regulations, Section 124.109) state that brokers are ineligible to participate in the Section 8(a) Program, since brokers do not satisfy the definition of a manufacturer or regular dealer.

The FIRMR Sections 201-1.103 and 201-24.202 and the Defense Federal Acquisition Regulation Supplement Subpart 270.6 allow contractors to purchase computer equipment for the Government. However, buying computer equipment through contractors can limit competition and increase contract costs. If PSI had been successful in procuring the processor, the NMPC may have paid substantially more than it would have paid if it had made the purchase directly from the manufacturer or a regular dealer.

The Walsh-Healey Act requires that contracts for more than $10,000 for the manufacturing or furnishing of materials, supplies, articles, or equipment may be awarded only to the manufacturer or regular dealer of the items. The FAR, Part 22.6, implements the Act and provides specific definitions for both a manufacturer and a regular dealer:

> "Manufacturer" . . . means a person that owns, operates, or maintains a factory or establishment that produces on the premises the materials, supplies, articles, or equipment required under the contract and of the general character described by the specifications.

> "Regular dealer" . . . means a person that owns, operates, or maintains a store, warehouse, or other establishment in which the materials, supplies, articles, or equipment of the general character described by the specifications and required under the contract are bought, kept in stock, and sold to the public in the usual course of business.

Based on these definitions, PSI's effort to buy a secure processor for the Government was in conflict with the Act, and it is our opinion that PSI was acting as a broker for NMPC. PSI did not physically manufacture computer processors nor did it stock and sell computer processors to the public. PSI planned to meet NMPC's needs by purchasing the processor from other sources, IBM or ViON. On August 3, 1988, IBM granted PSI a "Federal Systems Integrator" status agreement. The status agreement authorized PSI to procure equipment from IBM for the NMPC. According to this agreement, PSI would neither stock the processor nor use its own funds to purchase the equipment. Instead, IBM would be responsible for the delivery and installation of the processor and would receive payment directly from the Government once the equipment was accepted. PSI would have incurred little risk and would have performed no substantive tasks except to make the buy. PSI did not establish an agreement with ViON, so we were unable to determine the responsibilities to be assumed by either company.

Limited Competition. When a contractor buys materials, supplies, articles, or equipment for the Government, the contractor is not required to solicit and select sources according to the same standards and procedures applicable to the Government. For example, a contractor does not have to meet the same level of competition as the Government when conducting procurements.

The Competition in Contracting Act of 1984 (the Competition Act) (Public Law 98-369) applies to Government agencies and requires them to obtain "full and open competition," meaning that all responsible sources are permitted to submit offers and receive consideration. The requirements of the Competition Act do not, however, extend to Government contractors who, instead, must follow requirements in the contract. One of those requirements may be the Competition in Subcontracting clause (FAR 52.244-5), which is a standard contract clause used, with some exceptions, in contracts exceeding $25,000. The clause

states, "The contractor shall select subcontractors [including suppliers] on a competitive basis to the maximum practical extent, consistent with the objective and requirements for the contract." The impact of the clause on competition is not clear. No standard regulatory requirement exists to define "maximum practical extent," and not all contracts include the clause. As a result, when the Government has a contractor purchase supplies and equipment on its behalf, the Government may not receive the same level of competitiveness as with "full and open competition."

Additional Cost. If the processor had been purchased through PSI, the NMPC may have paid substantially more than it would have paid to purchase the processor directly from the manufacturer or a regular dealer. Documents generated during PSI's evaluation of the IBM and ViON proposals showed that PSI was planning to charge a significant percentage of the equipment cost to buy the processor for the Government. However, PSI's incurred labor costs during the negotiations with IBM, the solicitation of bids, and the evaluation of the price proposals, were already indirectly charged to the contract as field overhead. If PSI had contracted with the Government to purchase the processor, PSI would have been entitled to recover those contract costs that were reasonable, allowable, and allocable (FAR 31.201-2). In our opinion, it would be unreasonable to compensate PSI on the basis of equipment costs, because PSI was assuming little responsibility and risk and had already been reimbursed for its labor costs. We could not determine whether NMPC had agreed to pay the additional markup. The markup would still be subject to negotiation and approval by the contracting officer.

Contract Costs. While reviewing contract costs for the PSI contract, we became aware of potential mischarging of costs by PSI. The Defense Contract Audit Agency (DCAA) is responsible for auditing cost-type contracts to ensure that incurred costs are reasonable, allowable, and allocable. Because the contract is still open, DCAA has not performed the audit. The DCAA provisionally approved the payments to PSI subject to a cost-incurred audit before the contract ends. Because PSI will soon lose its Section 8(a) status and because it relies almost exclusively on Government contracts, we believe that it is in the Navy's interest to request a cost-incurred audit now. We noted three areas where cost mischarging may have occurred:

- A cost pool for field overhead, which is normally used to collect labor-related fringe benefits (such as health and retirement benefits), included charges for nonlabor-related costs

such as rent, telephone, utilities, depreciation, and a number of indirect labor charges. The field overhead is assigned to the contract based on direct labor dollars. Since the Navy is providing Government buildings to PSI, we question the reasonableness of assigning such costs to the NMPC contract.

- PSI leases office space at three locations. We were told by a former PSI official that one of the offices was used so that PSI could operate through the SBA's Region I, headquartered in Boston, Massachusetts. We were also told that the office is an unstaffed apartment. PSI records show that this Boston office is the headquarters for PSI, although company records and officers of the company are assigned to the Fairfax, Virginia, office. FAR 31-205-17(b) states that the costs of idle facilities are unallowable unless facilities are necessary to meet fluctuations in work load or are idle due to unforeseen circumstances, such as changes in requirements and production economies.

- Certain real estate properties leased by PSI were not leased from independent third parties. Instead, the properties were owned by a limited partnership in which the owner of PSI had a 50-percent interest. We believe that the DCAA should review the leases to determine whether the Government is being charged more than fair market value and whether PSI needs the leased space.

Other Issues. During the audit, we became aware of certain PSI practices that did not follow SBA regulations on eligibility for participation in the Section 8(a) Program. These practices concerned levels of subcontracting, consulting arrangements, and Standard Industry Classification Codes. We brought these issues to the attention of the SBA's Office of the Inspector General.

Recommendations for Corrective Action

1. We recommend that the Deputy Assistant Secretary of Defense (Procurement) direct the Defense Acquisition Regulatory Council to amend the Defense Federal Acquisition Regulation Supplement to prohibit vendor training or presentations on the preparation of contract specifications, statements of work, evaluation factors for contract award, or other related topics that may give the vendor an unfair advantage in competing for a contract or otherwise restrict competition. Our suggestion of examples of the kinds of conduct, both permissive and prohibited, that should be considered in the amendment is provided at Enclosure 1.

2. We recommend that the OSD Standards of Conduct Officer submit to the DoD Ethics Oversight Committee for consideration the addition of a Conflict of Interest Prohibition in DoD Directive 5500.7, "Standards of Conduct." The addition should prohibit DoD personnel from participating in presentations or training sessions on the preparation of contract specifications, statements of work, evaluation factors for contract award, and similar related topics provided by vendors that provide or appear to provide an unfair advantage to that vendor in competing for subsequent contracts or that could otherwise restrict competition.

3. We recommend that the Commander, Naval Military Personnel Command:

a. provide training in Federal procurement regulations and procedures for personnel involved in the procurement of automatic data processing equipment for the Government.

b. require that during acquisitions of automatic data processing equipment, procurement personnel be prohibited from using brokers in accordance with Federal Acquisition Regulation Subpart 22.6, restrict contracting actions to authorized contract officers in accordance with Federal Acquisition Regulation Section 15.604, and restrict contractor-performed work to the scope of the contract.

4. We recommend that the Commanding Officer, Naval Regional Contracting Center, Washington, request that the Defense Contract Audit Agency perform a cost-incurred audit of the Naval Military Personnel Command contract with PSI International, Incorporated (Contract number N00600-86-C-2922).

Management Comments

On October 2, 1989, a draft of this report was provided to the Deputy Assistant Secretary of Defense (Procurement); the Office of General Counsel, DoD, and the Assistant Secretary of the Navy (Financial Management). Comments from the Office of General Counsel, DoD, were received on October 26, 1989, and comments from the Assistant Secretary of Defense (Production and Logistics) and the Under Secretary of Navy were received on November 15 and November 16, 1989, respectively. Management comments are provided as Enclosures 2, 3, and 4.

The Assistant Secretary of Defense (Production and Logistics) generally concurred in the need for corrective action on the training of Government personnel by vendors with a stake in future procurements, but stated that the FAR provisions on

Organizational Conflict of Interest were adequate to cover the cases disclosed by the audit. The Assistant Secretary agreed to issue a policy memorandum to the Services and Defense agencies to emphasize the application of those provisions.

The Office of General Counsel, DoD, also concurred with our recommendation to submit to the DoD ethics Oversight Committee the addition of a Conflict of Interest Prohibition to prohibit DoD personnel from participating in presentations or training sessions on the preparation of contract specifications, statements of work, evaluation factors, and related topics provided by vendors that provide or appear to provide an unfair advantage to the vendor. If the Committee determines a need for an addition to the "Standards of Conduct" Directive, then the change will be made to the next draft revision of the Directive. Revision of the Directive will begin as soon as the Office of Government Ethics promulgates its regulation, which is expected before the end of the year.

The Under Secretary of the Navy concurred with our recommendation to conduct training in Federal procurement regulations and procedures for personnel involved in the procurement of ADP equipment. The proposed NMPC training will include the requirements in the FAR and other Federal ADP equipment procurement guidelines as they pertain to Government employees involved in the procurement process. The estimated completion date of this course is March 31, 1990. The training will be provided in addition to required training for COTR's. Training in Standards of Conduct and Ethics is provided quarterly. The NMPC also sponsored an "Ethics in Government" briefing in June 1989.

The Under Secretary also concurred with our recommendation to prohibit NMPC procurement personnel from using brokers when acquiring ADP equipment, to restrict contracting actions to authorized contracting officers, and to restrict contractor-performed work to the scope of the contract. NMPC requires all of its employees to comply with requirements of the FAR. This requirement will be reinforced in its training program to be completed on March 31, 1990. The Chief of Naval Personnel (CNP) has established a number of management controls to ensure compliance with acquisition regulations. NMPC will routinely review procurement plans, including acquisition strategies for each procurement at quarterly CNP Program Reviews to ensure competition, noted acquisition regulations compliance, market surveys, and industry participation as appropriate. In addition, NMPC has established a CNP competition review panel to ensure that all procurements are thoroughly planned and researched with

statements of need that are set forth in the least restrictive terms possible. Annual industry briefings will be conducted to ensure the widest possible dissemination of acquisition intentions. In future CNP sponsored standards of conduct and ethics training, strong emphasis will be placed on compliance with Federal procurement regulations.

The Under Secretary also concurred with our recommendation for the NRCC to request the Defense Contract Audit Agency perform a cost-incurred audit of the NMPC contract with PSI. The NRCC requested the audit on October 19, 1989.

Management comments satisfied the requirements of DoD Directive 7650.3; therefore, a reply to the final report is not required. We have determined that monetary benefits will not be realized by implementing Recommendations 1., 2., 3., and 4. The courtesies extended to the audit staff (see Enclosure 6) are appreciated. If you have any questions about this audit, please contact Mr. Terry L. McKinney at (202) 693-0430 (AUTOVON 223-0430) or Mr. Kent E. Shaw at (202) 693-0440 (AUTOVON 223-0440). Copies of the final report are being provided to the activities listed in Enclosure 7.

Stephen A. Trodden
Assistant Inspector General
for Auditing

Enclosures

cc:
Secretary of the Navy
Director, Defense Acquisition Regulatory Council

EFFECTS ON COMPETITION BY VENDOR PRESENTATIONS

EXAMPLES

Examples that would result in an unfair competitive advantage:

- A computer vendor provides training to Government procurement personnel on preparation of request for proposals for an upcoming contract that the vendor may bid on.

- A computer vendor provides training to Government procurement personnel on preparation of specifications, the statement of work and types of evaluation factors, any of which may be used for an upcoming procurement that the vendor may bid on.

Examples that would not result in an unfair competitive advantage:

- A vendor makes a presentation of its product capabilities or proposed technical solution for a specific automation problem.

- A vendor provides training on how to use its firm's products.

- A vendor provides training on how a Government agency can procure computer equipment but the vendor does not sell hardware, software, or computer supplies to the Government, or have a direct interest in an upcoming contract.

- A vendor makes general presentations regarding technical advances made to product lines.

- Vendors respond to market surveys made by contracting officers.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D C 20301-8000

PRODUCTION AND
LOGISTICS

November 15, 1989

P/CPA

MEMORANDUM FOR THE INSPECTOR GENERAL

SUBJECT: "Review of Naval Military Personnel Command (NMPC) Planned Procurement of Automated Data Processing Equipment Project No. 9ID-5005.1"

This is in response to your request for comments regarding Recommendation 1 of the subject report. The finding concerns training of government personnel by vendors with a stake in future procurements and, therefore, the appearance of possible unfair advantage. We generally concur in the need for corrective action and believe the principles in FAR 9.5, Organizational Conflict of Interest, are adequate to cover cases like this. In view of your finding, we will issue a policy memorandum to the Services and Defense Agencies to emphasize the application of those principles.

Jack Katzen

ENCLOSURE 2

DEPARTMENT OF DEFENSE
OFFICE OF GENERAL COUNSEL
WASHINGTON, D C 20301-1600

26 OCT 1989

MEMORANDUM FOR DIRECTOR, READINESS AND OPERATIONAL SUPPORT
DoD INSPECTOR GENERAL

SUBJECT: Draft Report on the Audit of the Naval Military Personnel Command (NMPC) Planned Procurement of Automated Data Processing Equipment (Project No. 91D-5005.10)

Attached please find the response for Recommendation 2 of the draft report, subject as above. I hope this will be helpful to you. If you have any questions, please contact Randi Elizabeth DuFresne, of the Standards of Conduct Office, at 697-5305.

L. Niederlehner
Deputy General Counsel

Attachment

RECOMMENDATION FOR CORRECTIVE ACTION

2. We recommend that the OSD Standards of Conduct Officer submit to the DoD Ethics Oversight Committee for consideration the addition of a Conflict of Interest Prohibition in DoD Directive 5500.7, "Standards of Conduct". The addition should prohibit the participation by DoD personnel in presentations or training sessions on the preparation of contract specifications, statements of work, evaluation factors for contract award and similar related topics provided by vendors, that provide, or appear to provide an unfair advantage to that vendor in competing for subsequent contracts or could otherwise restrict competition.

DoD RESPONSE: Concur. The Standards of Conduct Office will submit this issue to the DoD Ethics Oversight Committee for consideration. If the Committee determines a need for an addition to the DoD Directive 5500.7, "Standards of Conduct", then language will be drafted and included in the next draft revision of the Directive. Revision of the Directive will begin as soon as the Office of Government Ethics promulgates its regulation, which is expected before the end of the year.

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D C 20350-1000

16 November 1989

MEMORANDUM FOR THE DEPARTMENT OF DEFENSE ASSISTANT INSPECTOR GENERAL FOR AUDITING

Subj: AIG(A) DRAFT REPORT: REVIEW OF NAVAL MILITARY PERSONNEL COMMAND (NMPC) PLANNED PROCUREMENT OF AUTOMATED DATA PROCESSING EQUIPMENT, PROJECT NUMBER 9ID-5005.1 - INFORMATION MEMORANDUM

I am responding to your memorandum, TAB A, concerning the Naval Military Personnel Command's (NMPC) procurement practices.

The Department of the Navy response to the draft audit report is provided at TAB B. We have carefully reviewed and concur with the draft report's finding and recommendations. The Department is taking the necessary actions to correct the noted deficiencies.

The Chief of Naval Personnel (CNP) has published a Procurement Policy for Automated Data Processing (ADP) procurements which reemphasizes competition and industry notification and comments. CNP has established a number of management controls to ensure compliance with acquisition regulations. These initiatives are addressed in our response to Recommendations 3a and 3b of subject report.

J. Daniel Howard
Under Secretary of the Navy

TAB A - DOD AIG(A) memo of 2 Oct 89
TAB B - Department of the Navy Comments on Draft Report

Department of the Navy Comments
on
OAIG(A) Draft Report of October 2, 1989
on
Review of Naval Military Personnel Command (NMPC) Planned Procurement of Automated Data Processing Equipment
Project No. 9ID-5005.1

Summary of OAIG(A) findings and recommendations

AIG(A) found that NMPC's efforts, through PSI International, Incorporated (PSI), to negotiate prices exclusively with International Business Machines Corporation (IBM) for the acquisition of a secure processor circumvented full and open competition; that NMPC's Contracting Officer's Technical Representative (COTR) took actions that were outside the scope of his authority; that PSI acted outside the scope of its contract in attempting to purchase equipment for NMPC; and that there is potential mischarging of costs on NMPC's contract with PSI.

AIG(A) concluded that these conditions were caused by the project manager's unfamiliarity with Federal procurement regulations and inadequate NMPC management controls.

AIG(A) recommendations to the Department of the Navy were:

- NMPC provide training in Federal procurement regulations and procedures for personnel involved in the procurement of ADP equipment; require that during acquisitions of Automated Data Processing (ADP) equipment, procurement personnel be prohibited from using brokers in accordance with the Federal Acquisition Regulation; restrict contracting actions to authorized contract officers in accordance with the Federal Acquisition Regulation; and restrict contractor-performed work to the scope of the contract.

- Navy Regional Contracting Center (NRCC), Washington request that the Defense Contract Audit Agency perform a cost-incurred audit of the NMPC contract with PSI.

Department of the Navy Statement

Finding: Circumvention of Full and Open Competition. AIG(A) found that the NMPC's efforts, through PSI International, Incorporated (PSI), to negotiate prices exclusively with International Business Machines Corporation (IBM) for the acquisition of a secure processor circumvented full and open competition. Because PSI does not, in the usual course of

business, manufacture nor stock and sell computer processors to the public, AIG(A) believes that a broker relationship, contrary to existing laws and regulations, was created between NMPC and PSI in the attempted procurement. AIG(A) found that the NMPCs Contracting Officer's Technical Representative (COTR), who was the project manager for the procurement, took actions to solicit bids, conduct negotiations, and perform price analyses, that were outside the scope of his authority. Additionally, PSI acted outside the scope of its contract in attempting to purchase equipment for NMPC while NMPC was engaged in an unsuccessful attempt to modify the contract to include that service. Further, PSI did not notify the contracting officer in writing, as required under the terms of its existent contract, that work outside the scope of the contract had been requested by NMPC, prior to taking action on the request. AIG(A) believes that these conditions were caused by the project manager's unfamiliarity with Federal procurement regulations, and that the resultant negotiation gave the appearance of favoritism toward IBM. AIG(A) believes that using PSI, a Section 8(a) contractor, as broker in the procurement was in conflict with the Walsh-Healey Act and the SBA regulations on eligibility for participation in the Section 8(a) Program. The procurement attempt through PSI resulted in closed competition and noncompliance with procurement regulations. AIG(A) did not identify any improper actions on the part of IBM.

During the audit, AIG(A) also became aware of potential mischarging of costs on NMPC's contract with PSI. Additionally, they noted other SBA regulatory issues that AIG(A) brought to the attention of the SBA's Office of the Inspector General.

Department of the Navy Response: Concur. See actions taken in response to recommendation 3 and 4.

Recommendation 3: That the Commander, Naval Military Personnel Command:

a. provide training in Federal procurement regulations and procedures for personnel involved in the procurement of automated data processing equipment for the Government.

b. require that during acquisitions of automatic data processing equipment, procurement personnel be prohibited from using brokers in accordance with Federal Acquisition Regulation Subpart 22.6, restrict contracting actions to authorized contract officers in accordance with Federal Acquisition Regulation Section 15.604, and restrict contractor-performed work to the scope of the contract.

Department of the Navy Response: Concur.

a. NMPC will develop and conduct a training program for all persons involved in the procurement of Automated Data Processing Equipment (ADPE) for the government. This class will include the requirements in the Federal Acquisition Regulations (FAR) and

other Federal ADPE procurement guidelines as they pertain to government employees involved in the procurement process. The estimated completion date of this course is 31 March 1990. To comply with NAVSUPINST 4330.6B, NMPC personnel are required to attend the Management and Administration of Contracts For Non-Contracting Personnel course before they can be designated as COTRs by NRCC. Additionally, NMPC sponsors quarterly Standards of Conduct and Ethics training and provides to general distribution the Bedrock Standards of Conduct. NMPC with Secretariat/ Headquarters Civilian Personnel Office (S/HCPO) sponsors a COTR Course. NMPC maintains a list of personnel who have completed the required COTR training and verifies each COTR nominee against this list before forwarding the appointment letter to NRCC for approval. NMPC also sponsored an "Ethics in Government" briefing in June of 1989.

b. It is the Naval Military Personnel Command's (NMPC) direction that all government employees comply with the requirements of the Federal Acquisition Regulations. We will reinforce this requirement to all government employees involved in the procurement of ADPE through the training program. The estimated completion date of this course is 31 March 1990. CNP has established a number of management controls to ensure compliance with acquisition regulation. We will routinely review procurement plans, including acquisition strategy for each procurement at quarterly CNP Program Reviews to ensure competition, compliance with noted acquisition regulation deficiencies, market surveys, and industry participation as appropriate. We have established a CNP competition review panel to ensure that all procurements are thoroughly planned and researched with statements of need that are set forth in the least restrictive terms possible. We will establish annual industry briefings to ensure the widest possible dissemination of Command acquisition intentions. In future CNP sponsored standards of conduct and ethics training, strong emphasis will be placed on compliance with Federal procurement regulations.

Recommendation 4: That the Commanding Officer, Naval Regional Contracting Center, Washington, request the Defense Contract Audit Agency perform a cost-incurring audit of the Naval Military Personnel Command contract with PSI International, Incorporated (Contact number N00600-86-C-2922).

Department of the Navy Response: Concur. An audit request was made on 19 October 1989. See attachment A.

DEPARTMENT OF THE NAVY
NAVAL REGIONAL CONTRACTING CENTER
WASHINGTON NAVY YARD
WASHINGTON, DC 20374-2004

TELEPHONE
AC-202-433-
AV-288-
TWX-710-822-9452

IN REPLY REFER TO

OCT 19 1989

From: Commanding Officer

To: Defense Contract Administration Services Management Area - Baltimore, 200 Towsontown Blvd., West Towson, Md 21204-5299

Subj: REQUEST FOR A COST INCURRED AUDIT ON CONTRACT N00600-86-C-2922

Ref: (a) Draft Inspector General Report "Draft Report on the Audit of the Naval Military Personnel Command (NMPC) Planned Procurement of Automatic Data Processing Equipment (No. 9ID-5005.1)

1. Pursuant to reference (a), it is requested that a cost-incuured audit is performed on PSI and all subcontractors for subject contract.

2. It is requested that the audit specifically address the following areas:

a. Cost pool for field overhead

b. Office facilities, specifically the Boston office, as acceptable under FAR 31.205-17(b).

c. Property leases to determine whether the Government is being charged more than a fair market value and whether the space is actually needed for PSI contract performance.

d. The internal procurement system within PSI to determine whether the Government is receiving the best price for all items procured under subject contract. Attention should also be drawn to procurement under competition as defined by the Federal Acquisition Regulations.

e. All costs incurred and invoiced for are within the statement of work and therefore within the scope of the contract. Particular attention should be addressed to procuremnts by PSI and its subcontractors under this contract.

3. In order for this command to present input to the Inspector Generals office all backup information developed by the auditor should be provided with the audit report. If any

exceptions are taken to the costs invoiced for by PSI, the basis for the advisory position should be detailed for each cost element.

4. It is requested that the report be provided to this office no later than 20 November 1989.

5. Problems encountered by the Administrative Contracting Officer (ACO) of Auditor which would preclude a complete and satisfactory examination should be directed immediately to Ms. Illona M. Williams, Code P7J, (202) 433-2895.

ILLONA M. WILLIAMS
by direction

Copy to:

Defense Contract Audit Agency
Silver Spring Branch
8757 Georgia Avenue, Suite 1416
Silver Spring, Md. 20910-3773

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Office of General Counsel, Washington, DC

Department of the Navy

Information Resources Management, Washington, DC
Office of General Counsel, Arlington, VA
Naval Military Personnel Command, Arlington, VA
Naval Regional Contracting Center, Washington, DC

Defense Activities

Defense Contract Audit Agency, Fairfax, VA

Non-DoD Activities

House Committee on Government Operations, Washington, DC
General Accounting Office, Washington, DC
General Services Administration, Washington, DC
Small Business Administration, Boston, MA
Office of the Inspector General, Small Business Administration, Washington, DC
Office of the Inspector General, Small Business Administration, New York, NY

Non-Government Activities

Amdahl Corporation, Washington, DC
International Business Machines Corporation, Bethesda, MD
Memorex Telex Corporation, Vienna, VA
National Capitol Systems, Incorporated, Washington, DC
NCR Comten, Rockville, MD
PacificCorp Capital, Inc., Reston, VA
PSI International, Inc., Fairfax, VA
Storage Technology Corporation, Silver Spring, MD
ViON Corporation, Washington, DC

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Terry L. McKinney, Program Director
Kent E. Shaw, Project Manager
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Richard Hanley, Team Leader
Bruce Shelton, Team Leader
Douglas A. Saunders, Auditor

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Office of Management and Budget
Small Business Administration

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Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on the Budget
Senate Committee on Governmental Affairs
Senate Subcommittee on Oversight of Government Management, Committee on Governmental Affairs
House Committee on Appropriations
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